New Ideas for the London Summit

Recommendations to the G20 Leaders

A Chatham House and Atlantic Council Report

CHATHAM HOUSE

THE ATLANTIC COUNCIL OF THE UNITED STATES

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Project Co-directors: Paola Subacchi and Alexei Monsarrat

March 2009

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Charity Registration No. 208223

ISBN 978 1 86203 216 3

Designed and typeset by Soapbox Communications Limited
www.soapboxcommunications.co.uk

Printed and bound in Great Britain by Latimer Trend and Co Ltd

The material selected for the printing of this report is Elemental Chlorine Free and has been sourced from sustainable forests. It has been manufactured by an ISO 14001 certified mill under EMAS.

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Foreword

Attempting to resolve the international financial and economic crisis has become one of the first major tests of the transatlantic relationship since the inauguration of President Obama in January 2009. Preparations for the London Summit of G20 leaders on 2 April 2009 have revealed some important differences between the US and European approach and among EU members themselves. To explore these differences and generate ideas on how best to overcome them in the midst of the financial and economic storm, Chatham House and The Atlantic Council of the United States brought together over 80 business leaders, financial experts and academics from Washington, New York, Brussels, Geneva, London, Paris and Rome in two one-day workshops.[1]

A number of these experts were commissioned to write brief policy papers which were presented and discussed at the two workshops, held within the same week in March 2009, in Washington, DC and London. These papers form the body of the report.

The workshops generated 24 concrete recommendations, each of which is important to help resolve the crisis and set the world economy onto a sustainable path to recovery. In the Executive Summary, we have grouped these recommendations according to the likely immediacy of their impact. G20 leaders will decide which combination suits their economic and political needs, but, as we note, the London Summit should focus substantially on actions that will have a positive near-term effect.

We would like to thank Paola Subacchi, Research Director, International Economics and Ruth Davis, Junior Research Fellow, International Economics at Chatham House, and Alexei Monsarrat, Director and James O'Connor, Assistant Director of the Global Business and Economics Program at The Atlantic Council of the United States, for their great efforts in pulling together the workshops and papers that have led to the development of this report.

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1. Chatham House's involvement is part of an ongoing major project on the changing dynamics of global economic power and the governance of the international financial and economic system.

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Executive Summary and Recommendations

Paola Subacchi, Alexei Monsarrat
and Robin Niblett

The London Summit matters

What started last year as a growing international credit crunch and, by September, a global banking crisis has now spread into the real economy. International trade, investment and economic growth are all contracting. A drastic curtailment of credit, collapsing global demand and a loss of trade finance is having a devastating economic effect on both the developed and developing worlds, especially those economies that are heavily dependent on exports.

The world economy is falling into a deep recession. After more than a decade of robust economic expansion that has contributed to improve the living conditions of millions of people, the current crisis threatens to reverse this progress and set in train a backward process of 'deglobalization' in both the developed and developing worlds.

The London Summit on 2 April provides a critical moment to broker international agreements and solutions among governments representing 80 per cent of global GDP on how to halt this collapse. The summit must restore confidence in the positive potential of an integrated world economy. It must demonstrate a shared commitment to the actions required to halt the crisis. And, to secure this shared commitment, it must set in place a rule-based and inclusive framework of international economic and financial governance.

With these imperatives in mind, the contributions to this report point to a set of overarching priorities for the London Summit. The summit should have an ambitious, but manageable and focused agenda that commits G20 governments to immediate and concerted action to stop the crisis in the short term and sets out specific targets and deliverables that will have a positive systemic impact over the medium to long term.

A focused agenda

The G20 is an informal governance mechanism with no experience in managing a crisis, and there is a limit to what it can accomplish. Since the first G20 leaders' summit in November 2008, the ever-worsening economic outlook has burdened the G20 process with expectations that are far too high and and agenda that is too complex. The existing G20 agenda of long-term financial reform has become entangled with immediate concerns about orderly crisis resolution and about the impacts of the crisis on the development and environmental agendas.

The immediate challenge now for the London Summit is to focus the agenda and embrace concerted action to stop the crisis. However, it is clear that immediate action by G20 leaders to halt the deepening recession will need to rest upon a central political trade-off. Agreement across the major G20 countries on the importance of stimulating the world economy (championed by the United States, United Kingdom and Japan) will require that G20 leaders also make specific commitments to international financial regulatory reform (as France, Germany and the majority of other EU leaders have consistently argued). With this compromise in place, the summit must also commit to halt any rise in protectionism, which could prove devastating for the world economy and especially for the developing world.

G20 leaders should commit, therefore, to two sets of actions at the London Summit – first, those that will have an immediate effect on stemming the crisis and, second, those that will have a longer-term structural impact.

Take action to the stop the crisis

1. *Leverage the crisis to achieve a sustained resumption of economic growth.*
2. *Immediately increase capacity for systemic crisis management.*
3. *Reject protectionism and promote open economies.*

Strengthen the international financial and monetary architecture

4. *Improve the financial regulatory framework*
5. *Fundamentally reform the governance of the international financial institutions*
5. *Address global imbalances*

It will not be sufficient for G20 leaders to issue general declarations at the London Summit. To be credible, there needs to be detail. We offer this sort of detail in the synopsis of the report's recommendations below.

Recommendations for action[1]

For immediate and short-term impact

1. Agree on a path to sustained resumption of economic growth

G20 leaders must articulate their conviction at the London Summit that stimulating economic growth with all appropriate policy tools is the first priority, and that sharing the burden will be essential to achieving this task.

a. Sending a unified message on this point is the only way to restore global confidence and show that the world economy is once again under 'adult supervision'. G20 nations have already taken major, but differentiated stimulus approaches, reflecting national policy priorities. The London Summit must commit G20 nations to using all policy tools to stimulate further their national economies and create traction for the entire world economy.

b. Rather than recommending one-size-fits-all fiscal stimulus packages, the G20 needs come up with a clear plan for establishing how countries are going to share the burden of the stimulus. Such a plan requires analysis of the key influences that determine the actual fiscal position and anticipated future debt burden of each major country. Each national plan must be cast in a credible medium-term framework and offer the prospect of generating sustainable growth as well as having an immediate impact.

c. US expansionary fiscal and monetary policies are putting downward pressures on the dollar, meaning that Eurozone countries and others are sharing the burden of US stimulus indirectly through the exchange rate. It is vital to avoid the emergence of competitive devaluations in this context.

d. A sub-group of the G20 should be established to review the performance of the stimulus packages and recommend necessary adjustments.

2. Immediately increase systemic capacity for crisis management

International institutions must be in a position to provide support to countries in dire need of financial assistance. This can best be achieved if the G20 agrees to increase the IMF lending facilities.

a. Japan and the EU have each now offered major new credit lines to the IMF ($100 billion and €75 billion, respectively). The US and other G20 members, especially those with large foreign exchange reserves, should follow suit at the summit and commit to other multilateral initiatives. For example, the Federal Reserve and other central banks already have swap lines with some emerging markets, and the Chiang Mai Initiative makes swap lines available to Asian countries.

b. As important as the amount of new lending available will be a commitment to reduce the stigma associated

1. While the contributors to this report have put forward and explore in some detail various and different recommendations, the editors take the responsibility for selecting the recommendations contained in this Executive Summary – in their opinion the strongest proposals, and most critical areas for action – and their sequence of action.

with IMF borrowing and make these sums more accessible to borrowers, in terms of total amount, conditionality and length of borrowing periods.

3. Reject protectionism and promote open markets

While increases in actual tariffs or other WTO-illegal actions remain low, protectionism is creeping in through non-tariff barriers as well as through measures devised to bail out specific sectors and industries. In order to withstand these growing protectionist pressures and preserve global cohesion, there are four steps which the London Summit could take that would be of immediate effect:

a. Formally commit to a collective 12-month freeze on new protectionist measures and a rolling back of existing measures. This includes those measures that are WTO-legal, such as raising applied tariffs to bound levels.

b. Define a plan to bind existing applied tariffs and make one or two bold proposals, such as removing trade and investment barriers in sectors such as clean technology products.

c. Commit to bring the Doha negotiations to a successful conclusion by the end of 2009 in order to support developing-world economies as well as the world economy. This must not be an empty gesture and should contain details of specific milestones for the remaining months of the year.

d. Empower the WTO and the IMF to monitor the rise of WTO-compatible protectionist measures and the impact of bailout programmes on trade and capital flows.

   It is vital to establish an international consultative group to discipline and make transparent the execution of support programmes to sensitive sectors, such as banks and automobile companies, and to minimize trade-distorting effects. G20 governments should commit to report immediately all changes in applied tariffs and subsidies to the WTO Secretariat, including all presumed WTO-legal measures under contingent protection, such as safeguards, countervailing duties, and antidumping initiations and sanctions. The WTO Secretariat should provide a written account as a background paper to future G20 summits.

The most effective way to defuse protectionist pressures is to reignite economic growth quickly. When governments and the public see the burden of delivering economic recovery policies as fairly shared across countries, this should reduce the political pressure for protectionist retaliation.

For medium- and long-term impact

4. Improve the financial regulatory framework

Agreeing at the London Summit to improved supervision and rules for financial institutions and instruments will help restore confidence in the financial sector – provided that countries resolve the issue of ‘toxic assets’ – and also help secure concerted action to drive forward measures to reignite growth. ***It is essential, however, that the regulation is appropriate and correctly targeted***. Rushed action could be counter-productive. Reforms should take account the substantial work already accomplished in international financial regulation, correct mistakes and fill gaps. The London Summit should commit to the following goals:

a. Commit to modifying the regulatory regime in order to reduce the pro-cyclicality of the financial industry.[2]

   This could be done in a number of ways, whether through dynamic provisioning, changes in mark-to-market accounting policies, the creation of ‘regulatory accounting policies’, a clearer monitoring of the term structure of funding versus loans, and of overall leverage in the system, and changes to the Basel II implementation.

b. Incrementally converge national financial rules.

   A gradual harmonization of financial regulations across borders (for example, defining an ‘institutional investor’, the number of settlement days for a transaction, or on valuation or auditing standards) would improve the common vocabulary of financial

2. The FSA definition of pro-cyclicality is that the term ‘refers to the tendency for regulatory capital requirements to rise with downswings in the economy and to fall with upswings’. See http://www.fsa.gov.uk/pubs/international/crsg_procyclicality_aide_memoire.pdf.

players, investors and regulators. Harmonization could be applied as narrowly or as widely as its success merited. By working on an incremental basis, regulators could choose subjects on which they already had agreement at the outset. Also, a small group of countries could agree to test selected topics on a trial basis and other countries could join in as they saw the success of the project. As other subjects of common agreement are found, a directory of common practices or common standards could be adopted across countries, regulators and regulated entities.

c. Take rating agency ratings out of legislation and capital rules.

Embedding of credit ratings in legislation and banking regulation has caused a dependence on a few suppliers, an inclination for financial market players to try to 'game' the outcome of the ratings, and an overdependence on these ratings by investors who should be doing more of their own analysis as well.

d. Enlarge the membership of the Basel Committee for Banking Supervision (BCBS).

This should occur along the same lines as for the FSF so that all countries with significant financial services sectors are included. Support for and implementation of BCBS proposals are likely to be more rapid and more consistent if these countries are involved from the outset, though drafting and negotiation will become more unwieldy among a larger membership.

e. Commit to an effective clearing and settlement mechanism for credit derivatives and other structured investment vehicles (SIVs).

This involves agreeing on common standards; standardization of contracts; an end to the over-the-counter market in credit derivatives; standardized margin requirements; and transparent price and volume data that are made publicly available.

5. Commit to fundamentally reform the governance of the international financial institutions

Strengthening the international financial institutions will help prevent future financial crises. The London Summit should commit to the following ideas:

a. Transform the Executive Board of the IMF into a world Economic Committee that is effective, high-level and inclusive.

The Economic Committee would focus on issues of policy spillovers that have collective macroeconomic impact, and involve large allocations of Fund resources. It would set the Fund's agenda.

b. The size of the IMF's financing capacity needs to be at least doubled, and ideally, tripled so that it can make a credible *long-term* commitment to help the most vulnerable countries. However, a fairer representation within the IMF will be vital if there is to be widespread agreement on recapitalizing the IMF

c. Collapse European representation in the IMF into a single chair or some other form of fundamental consolidation. As summit chair, the British government should take the lead in this process by volunteering at the London Summit to give up its single chair in the IMF as part of such a reform.

d. Increase the voting weight and representation of major emerging economies within IMF governance structures to reflect the realities of the new world economy.

e. Make the Financial Stability Forum (FSF) formally accountable to the G20.

The FSF's G7-centric membership has damaged its legitimacy, credibility and reputation, making its recent enlargement to all G20 members very welcome. The FSF should report and testify to the G20 ministers and their deputies, while giving the G20 a formal agenda-setting or directional mandate, allowing the G20 to set priorities and deadlines for FSF work.

f. Use the FSF for greater surveillance of market sectors.

Improve the FSF's understanding of how everyday credit practices and procedures relate to securitization, risk management techniques, credit rating agencies, the activities of hedge funds (and other non-bank institutions), and structured investment vehicles. The FSF needs greater powers to elicit testimonies and contributions from agencies such as the Federal Deposit Insurance Corporation, the Securities Investor Protection Corporation, the Securities and Exchange Commission, and the

Department of Housing and Urban Development in the United States.

g. Use the FSF for systemic or macro-prudential supervision.

Rather than creating a new body, FSF could perform this role. This could be accomplished by augmenting its strength, membership and authority. However, in order to avoid the continued proliferation of regulatory bodies, a precondition for the creation of any new regulator should be the closure of at least one, if not two others.

Address global imbalances

A focus on financial regulation and reform is insufficient to address some of the essential drivers of the financial crisis. To that end, the London Summit should agree to:

a. Ensure the continuation of IMF Multilateral Consultations on global imbalances.

These confidential consultations bring together surplus and deficit countries to discuss policies, exchange information and coordinate actions – in order to promote the growth of the world economy and prevent the build-up of instabilities in the international monetary and financial system

b. Set up a caucus on currency misalignments and for the promotion of monetary coordination.

This group would include China, Japan, the Eurozone and the US, with two rotating seats for G20 countries with the largest accumulation of foreign exchange reserves. Members of the group will formally commit to exchange information and enhance cooperation among the three main trading blocs: America, Europe and Asia.

Overcoming the challenges

We are under no illusion. Many of these proposals are very challenging and will require G20 leaders to spend a great deal of political capital. ***Strong leadership will be critically important to spur the most reluctant leaders to action***. The UK is chairing the London Summit and as such it needs to send a very strong signal about its commitment to reform. It is for this reason that this report contains the proposal that at the London Summit the UK should volunteer to give up its single chair in the IMF, which could then form part of an overall IMF reform agreement to streamline European representation.

G20 leaders need to communicate clearly to the public about the basis, rationale and sequencing of their actions in order to sustain popular support through what will be a protracted period of economic turmoil. When carrying out stabilization and stimulus policies, G20 leaders should also act transparently and be clear about the intentions of domestic policies so that they do not serve as a justification for future protectionist retaliation.

Introduction

Paola Subacchi

Context: agenda setting at the time of crisis

The first meeting of the G20[1] at the leader level was held on 15 November 2008, with the mandate to design 'a new international financial architecture'. Although this is a big task, it is part of a long-running process which has engaged the regulatory and financial community since the Asian financial crisis of 1997. The need for stronger supervision and regulation of financial institutions and markets, better transparency and the reform of the IMF and other international financial institutions have been on the agenda for over a decade. The key issue in November was to identify those measures necessary to prevent another financial crisis.

But in the few months between November 2008 and April 2009, spokespeople and lobbyists of all sorts (political, business, NGOs) have turned their gaze to the G20; it has become the *de facto* hub of global governance, eclipsing, for the moment at least, the G8, and expanding into ever new dimensions such as the low-carbon economy, energy efficiency, development and women's rights. As a result, very broad and long-term issues have become entangled with the immediate concern about orderly crisis resolution.

To date the ideas proposed and ad hoc actions taken by governments and the private sector have created more confusion than confidence. In the meantime the financial crisis has hit the real economy, with a massive contraction in activity across sectors and countries. The policy response so far has been patchy and uncoordinated, owing to different domestic conditions and governments' different abilities to channel resources into their respective economies. The US and China have unveiled fiscal stimulus packages worth hundreds of billions of dollars, interest rates have been cut to almost zero in the US, UK, China and Japan, and the UK has started the process of quantitative easing. Other countries have been less decisive, partly in response to different domestic conditions.

Working towards coordination

When countries began to unveil bailout plans and stimulus packages it became clear that these measures, even if they were technically within the remit of domestic economic policy, could have an adverse impact on neighbouring economies and trading partners, especially if they were introduced in a vacuum and mainly geared to maximizing the domestic impact of stimulus measures. Conversely, these measures could have a beneficial multiplier effect if they were applied in coordination with other economies.

As a result, policy coordination has been the buzzword in the months and weeks leading to the summit. However, coordination is easier said than done. Ultimately, it is the most advanced stage of a process that requires a significant modification of national policies in recognition of countries' growing international economic interdependence.[2] G20 leaders need to recognize that effective coordination must be preceded by strengthened consultation and cooperation. The G20 offers a vital new international forum for this process to evolve, starting with information-sharing (consultation), moving on to consensus-building on objectives (cooperation), and then laying out a framework for operational commitments (coordination).

1. Members of the G20 are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Republic of Korea, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom and the United States, as well as the EU (represented this year by the Czech Republic). Participants at the London Summit will include these countries as well as the Netherlands and Spain – and the heads of the UN, World Bank, IMF, the Chair of the New Partnership for Africa's Development (NEPAD), the Chair of the Association of South East Asian Nations (ASEAN), the President of the EU Commission and the Chairman of the African Union Commission.
2. This point is made by Henry C. Wallich in 'Institutional Cooperation in the World Economy', in Jacob A. Frenkel and Michael L. Mussa, eds, *The World Economic System: Performance and Prospects* (Doyer, Mass: Auburn House Publishing, 1984).

The linkages and complexity of the world economy require a deep understanding of the relationship between policy targets and the means to achieve them, as well as a full grasp of the right sequence at the national level. Without the right policy mechanism and the right policy sequence there is the risk of creating more instability and adverse effects. The way forward needs to address concerns for macroeconomic stability – both domestically and internationally – and for competitiveness, domestically. All these dimensions need to be organized in a coherent agenda. Most of all, policies at both international and domestic level need to be assessed in terms of impact and spillover so as to avoid undesired effects that nullify the impact and/or trigger 'beggar-thy-neighbour' effects.

If the G20 is to be successful in the long term, coordinated policy action among its members will require:

- Greater consistency between instruments, goals and timing including:
  - assigning the appropriate tools to each target;
  - assessing the policy impact at both macro and micro level;
  - looking at short-term vs long-term effects;
- Blending these dimensions into a coherent policy agenda; and
- Communicating policies effectively and responsibly, and guiding public opinion through the agreed measures.

As a result, it has become critical for G20 governments to review carefully the sequencing of the steps they must take at the G20 summit in London on 2 April. While the November summit identified a set of measures that is designed to prevent another financial crisis, we find ourselves in a position that requires immediate action to stop the current one.

The key issue now is to embrace immediate and concerted action to stop this crisis, rather than spreading valuable and limited political capital thinly over a range of areas that is too wide and unfocused. It is crucially important that the G20 leaders send a clear message to show that they are able to work constructively together; to do so will require trade-offs by all concerned. A coordinated response, the resumption of bank lending, arresting the rise in unemployment and a return of consumer confidence must be the top priorities for the London Summit. However, political agreement on the necessary steps to meet these objectives will be highly unlikely unless G20 leaders also commit explicitly to a small number of specific steps to increase the representative legitimacy of key international financial institutions such as the International Monetary Fund and the Financial Stability Forum, and to create more transparent, inclusive and well-regulated international financial markets. A commitment to addressing long-term and systemic issues will help build consensus for measures needed in the short term.

Structure of this report

The report is split into two sections which assess areas covered by the working groups set up after the 15 November summit, and a third section which considers the new agenda items for the London Summit that have risen to prominence since the G20 last met.

- Section 1 addresses regulatory reform in detail, looking at the tasks of the first two working groups, on 'Enhancing sound regulation and strengthening transparency' and on 'Reinforcing international cooperation and promoting integrity in financial markets'.
- Section 2 looks at the tasks of the third working group, on 'Reforming the IMF'. While the World Bank is an essential institution to provide developing countries with a path out of the crisis, it is the IMF that will address the systemic issues to help manage the global economy over the long term.
- Section 3 examines the threats that the crisis – as well as some of the potential solutions for managing its immediate impact – pose for growth and the international trading system, especially protectionism. It also considers how to address the serious problem of global imbalances.

1. G20 Working Group Issues: Reform and Rules

This section assesses and gives recommendations for G20 Working Group I: 'Enhancing Sound Regulation and Strengthening Transparency' and Group II: 'Reinforcing International Cooperation and Promoting Integrity in Financial Markets'

Executive Summary

Barbara Ridpath

The interconnectedness of the world's financial system and the interdependence of its players have become evident in the first clear crisis of globalization. The critical question this raises is whether we have a credible infrastructure for such a globally integrated financial system, and if we do not, what is needed to establish such an infrastructure. The submissions in this section pick up several, but by no means all, the areas in which work is needed if we are to come out of this financial crisis with a sounder, more robust financial architecture.

The contributions vary distinctly between those submitted for the US-based working group and those prepared for the London-based seminar, with the former having a strong focus on the US financial system. This is natural given the size of the US economy and the fragmentation of its regulatory structures. The US financial system is both large enough to consider its issues in isolation, and too large and important to do so without affecting the likelihood of effective solutions on an international basis. US policy-makers and legislators will have to ensure they focus sufficiently on improvements in the global financial and regulatory architecture as well as their domestic institutions for the forthcoming G20 meetings to produce lasting value in this crisis.

Just as active US participation is a precondition for success, so too is an understanding of what policy-makers are trying to achieve with financial regulation. There is still enormous work to be done on causality and lessons from the crisis, but it is worth taking the time to understand these, and to agree the objectives and purpose of regulation before anyone sets out to change it. Without such consensus, whatever is decided will be not be implemented effectively among the signatories, as each will interpret the new regulations in a way that suits its own purpose. In addition, it is important to recognize that no regulation or regulatory system is going to prevent another crisis. At best, this work can prevent the same type of crisis from recurring, or improve the early warning signals for the next one.

The third and perhaps most difficult precondition is that those attending the G20 meetings in London in April must try to put aside national interests to arrive at a regulatory and supervisory structure that aligns with the actual shape of the financial industry. While some still non-existent form of international regulation for major institutions may or may not be an improvement on the current domestic supervisors, it is clear that for the key institutions (many of which earn well over half their income outside their home markets), existing domestic supervision no longer fits their business model or geographic reach. The corollary to this is that any deposit guarantee system for these institutions, and any legal framework for bank rescue or insolvency, would also need to be cross-border – a very difficult concept indeed.

Subjects that the authors in these two working groups were asked to address elicited a wide variety of views and recommendations. While consensus was not reached on all issues, ideas coalesced around several key themes. The recommendations for which there was broad agreement are divided between those that can be implemented in the near term, and those that are either more 'architectural' in nature, or require further study. The latter are of no less importance, and should be added to future agendas. The individual submissions contain a wealth of further ideas that are worthy of study.

Bold Action for the G20 Summit

Douglas Rediker

With the London Summit rapidly approaching, I urge participants to take bold steps to address the fundamental structural issues in global finance that have, in part at least, led to the current economic crisis. I recognize that there remains a debate between those who believe that the current economic environment compels a dramatic rethink of the foundations, systems and structures upon which the global economy operates, and those who believe that such sweeping reforms are both unnecessary and politically impossible. In short, there are those who seek to begin the process of crafting a 'new Bretton Woods' and those who seek to ban the use of that phrase altogether.

I fall into the former camp.

The global financial sector is in need of structural reform. I believe that the current economic crisis provides an opportunity to reshape the global financial system in ways that more accurately reflect the global nature and risks inherent in 21st-century banking, finance and capital flows. The leaders at the London Summit should collectively announce one or more bold steps to demonstrate that this will not be an exercise in 'kicking the can down the road' but rather a recognition both of what is at stake and that now is the time to frame a global collective response.

Participants at the London summit are widely representative. Given the unofficial nature of the London Summit and the G20 – a group with no formal voting rules, enforcement power or vetoes – the gathering represents a true 'free market' where there is competition for ideas, creativity and leadership. It provides the perfect opportunity for a 21st-century successor to the intellectual and creative leadership of John Maynard Keynes to emerge.

To be successful, it is imperative that the United States play an active leadership role at the London Summit. The US has a unique role. It is the world's largest economy and the incumbent provider of global economic stability and ballast – through the size of its market and the reserve currency status of the US dollar, and as the world's leading financial centre and capital market. The failure of the US to assume a leadership role, especially with the presence of President Obama, would undoubtedly be seen as an opportunity missed.

Thus far, publicly at least, the most innovative and bold structural proposals have come from Europe, where a recent report by the High Level Group on Financial Supervision in the EU, under the direction of Jacques de Larosière, contains some very worthy, realistic and detailed recommendations. Unofficial groups, such as the G30 Financial Reform Working Group chaired by Paul Volcker, have similarly issued reports which I urge summit participants to review carefully and consider seriously. While I will not take up space here to repeat the specific recommendations of these two reports, I point to them as examples of the type of thinking that should be in evidence at the London Summit. In particular, I note the EU recommendation for the creation of a European Systemic Risk Council. The proposal is important because it seeks to address the systemic nature of risk, which underpins the existing financial system, and also because of its inherent inconsistency – which, in this instance, I consider a virtue. It is inconsistent because if the risk is systemic, then, by definition, it cannot be limited to Europe but must in fact encompass the global 'system'. That is a virtue, because it is a proposal which can be scaled to include a commitment by all London Summit participants – not just those who are members of the EU.

I urge participants to expand the possibilities for cross-border, global structural initiatives to address a crisis, the scale of which is already beyond anything considered possible only months ago. Failure to do so may well be seen in the future as a failure of imagination.

While not attempting to put forward comprehensive recommendations for such bold reforms, I would nevertheless like to propose certain areas for consideration.

I believe that Summit participants should embrace a deeper exploration of how 'risk' is integrated into the global financial system. Risk is the cornerstone of our financial system, but how it is treated is one of the most misunderstood aspects of what is at the very core of needed reforms.

As governments play an increasingly large role in the global financial system, it is imperative that those proposing reforms consider the enormous differences between those who approach risk as lawyers, politicians and policy-makers – for whom, in general, risk is something to be avoided and/or mitigated – and those in the financial sector, for whom it is something to be valued and managed. That distinction is of enormous consequence. Any proposals to reform the global financial system must take into account these fundamentally different approaches to risk.

This may ultimately result in a bifurcated financial system in which the more risk-averse are drawn to a more traditional banking model, and where the systemic nature of the banking sector makes it worthy of government intervention and taxpayer support. Those entities that seek to take on more sophisticated financial-sector activities, wherein risk is valued and managed, would be excluded from the banking sector and would fall into a non-bank financial services sector. As proposed in the G30 report and elsewhere, there are a number of different proposals to ensure that this sector is regulated on a globally coordinated basis to ensure that innovation is not destroyed but systemic threats are kept under control. These proposals need to be considered in great detail.

A further observation is that, to be truly effective, supervision of the global financial system requires not only coordinated supervision but coordinated enforcement. The global nature of capital flows and the risk of regulatory arbitrage require that specific and enforceable sanctions are coordinated on a global basis. This is not a call for a 'super-regulator', but it is a call for individual countries to recognize that sophisticated financial professionals are paid to execute transactions to create revenue and profit from the opportunities that such arbitrage presents. To expect the individuals or the firms that employ them to do otherwise is to misunderstand their fundamental job description.

I recommend consideration of the recognition that those who engage in the provision of banking services are acting in a capacity that is crucial to the successful functioning of national and international society.

It is for this reason that governments around the world have been compelled to provide enormous amounts of capital and other support to the banking sector in the recent turmoil and trauma. In this regard, it should not be unrealistic to expect those who provide these crucial services to be individually licensed (not just regulated) to do so – as is the case with lawyers, doctors and other professional service providers. As part of this reconsideration of the role of financial professionals, I recommend consideration of a code of professional responsibility for those engaged in certain banking and financial activities.

As the system is currently constituted, the responsibility for risk management rests primarily with the institution, not the individual. When combined with individual incentive structures that virtually invite risk-taking beyond what might be considered prudent for the institution or, ultimately, the financial system as a whole, the structure provides limited personal responsibility with enormous potential reward. Executive compensation caps do not fully address this.

While I strongly support much needed reforms to existing incentive and compensation structures, I further recommend the adoption of a set of basic, but binding, professional guidelines with which individual financial services professionals' behaviour should comply. This would at least begin to address a fundamental structural weakness in the current financial system, which is riddled with inherent conflicts. Unless we change the individual's responsibilities as well as incentives, the reforms necessary to the financial system may well fail to address fundamental issues.[1]

The global economic climate has deteriorated significantly since the November 2008 G20 summit. The issues

1. Unless the regulation, incentives and responsibilities of the financial services industry are changed, then even a return to economic growth and a restored housing sector will not fundamentally address the causes of the current crisis. Financial professionals are paid enormous sums to structure, sell and trade complex financial products. The fact that housing was the underlying asset upon which many of these structures were based does not mean that a similar bubble could not occur with another underlying asset. Clearly the size of the housing market made this crisis worse than it might otherwise have been, but fixing housing will not fix the financial system. Had it not been housing, it could have been consumer debt, credit cards or possibly something else that would have been ripe to serve as the underlying asset around which an unregulated culture of derivatives and securitized products would have been created.

become more serious by the day. I fully recognize how difficult these issues are and further how complicated it is to coordinate even a simple meeting of world leaders – much less one as crucial (and large) as the London Summit. An enormous task has been set before the countries that will be participating and leading the effort. But it is precisely because the global economic crisis has become so severe that bold action is required. Countries must seek to find common ground.

Given the magnitude and scale of the issues now confronting summit participants, those officials tasked with its preparation should not feel bound to adhere strictly to the agenda and working groups created four months ago. Those seeking to take an active leadership role in solving this crisis, in particular the United States, should consider bold steps and proposed revisions to that agenda to more comprehensively reflect the current global economic crisis.

Now is not the time for caution, but rather the time for bold assertion of leadership, ideally by the United States, but hopefully with the collective support of the global community. There is much at stake.

The G20 Agenda: Financial Standards and Regulation

Nicolas Véron

Representing about two-thirds of the world's population, four-fifths of world trade, and nine-tenths of world GDP or market capitalization, the G20 is strong on legitimacy.[1] But the very diversity of its constituent countries means it cannot act as an executive body, something that even the smaller and more homogeneous G7 always struggled to be. Thus the G20 cannot aim at running global financial regulation itself. Nor can it realistically empower one single institution, whether the International Monetary Fund, Financial Stability Forum (FSF) or any other, to play an overall coordinating role, as preparations for the November summit made quite clear. Rather, the G20 should rely on specialized global institutions for tackling individual challenges for which national or regional responses are insufficient.

In such an approach, the role of the G20 in economic and financial regulation will be to endorse and empower such institutions, which include the FSF, the Basel Committee on Banking Supervision (BCBS), and the International Accounting Standards Board (IASB), as well as global treaty-based organizations such as the IMF or World Trade Organization; to ensure these institutions' governance makes them legitimate enough to be effective; to foster initiatives to fill gaps in the extant regulatory landscape; and to help the resolution of differences in cases of overlapping or conflicting mandates. This is consistent with the inherently political and non-specialized nature of the G20, now that its meetings are conducted at the level of heads of state and of government.

The following remarks are focused on three specific issues within the scope of the current G20 working groups on 'enhancing sound regulation and strengthening transparency' and 'reinforcing international cooperation and promoting integrity in financial markets'.

Prudential standards

The Basel II capital accord is widely recognized as a marked improvement on pre-existing arrangements. It cannot be blamed for a crisis that originated before its implementation. However, several tenets of Basel 2 – including its reliance on banks' internal risk measurements and on credit ratings, or its risk-weighting of property-based financial instruments – have been called into question by the early lessons from the crisis, and will require revision. Moreover, the crisis has underlined the importance of multi-year financial cycles and has exposed the potential procyclical effect of capital regulation. Thus the setting of prudential standards will be under the spotlight in the years to come.

This will inevitably lead to questioning the governance and due process of standard-setting within the BCBS. The committee currently includes 13 countries: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. The absence of China from this list has become an anomaly since large Chinese banks have risen to the top ranks globally, and if China is included there may be pressure to include other large emerging countries too.[2] Separately, the standard-setting process has been criticized in retrospect as having been somewhat captured by the global banking industry, raising questions as to the

1. It is assumed here that the G20 format remains the reference for regular high-level gatherings on economic and financial issues – even if more participants, including countries such as Spain and the Netherlands and international organizations, are invited to the meetings.
2. As of 31 December 2008, three of the world's top five banks by market capitalization, including both the first and the second, were Chinese (Industrial and Commercial Bank of China, China Construction Bank and Bank of China); the other two were JP Morgan Chase and HSBC. Source: FT Global 500 ranking.

autonomy and guiding principles of this process, in order to ensure greater effectiveness.

As regards the substance of the changes to be brought about, the G20 should avoid being too prescriptive. The aim of reducing procyclicality is widely shared, and many voices have called for the introduction of a version of 'dynamic provisioning' such as has long been practised in the Spanish banking industry. However, dynamic provisioning in a global prudential framework is fraught with challenges and there is no guarantee of finding satisfactory responses. The G20 should not prejudge which technical choice will be most appropriate.

Accounting standards

Since the G20 meeting of 15 November 2008, the International Accounting Standards Committee Foundation (IASCF) – the private-sector foundation that appoints, finances and oversees the IASB – has adopted a reform of its governance framework to submit itself to a 'Monitoring Board' that includes representatives from the US Securities and Exchange Commission, European Commission, Japanese Financial Services Agency and International Organization of Securities Commissions (IOSCO).

This significant change is unlikely to resolve all questions raised by the IASB's governance.[3] Especially intriguing in the context of transition from G7/G8 to G20 is the limited representation it gives to large emerging economies, above all China, which will only be represented in the Monitoring Board through the (rotating) chair of IOSCO's Emerging Markets Committee. Equally problematic in the long run is the absence of representation of the global community of users of financial information, primarily investors: it should not necessarily be assumed that the Monitoring Board's members can represent them properly. However, none of these issues is urgent, and in April 2009 the G20 should probably limit itself to taking note of the creation of the Monitoring Board, if, as is currently expected, it has been created by that time.[4]

More topically, the G20 may take stock on the status of worldwide adoption of International Financial Reporting Standards (IFRS – the standards set by the IASB) in the context of a new US administration. Mary Schapiro, the new Chair of the Securities and Exchange Commission (SEC), has signalled a more cautious approach to IFRS adoption in the US than her predecessor. There is now a distinct possibility that even if adoption of IFRS remains a long-term goal, it may not happen in the United States within the next five years at least. This is not necessarily a problem, but would warrant a discussion at the level of the G20.

Controversies on the role of so-called 'fair-value accounting' in the crisis are likely to abate somewhat compared with the November 2008 summit, given both the IASB's initiative to create a global working group of respected individuals on this matter, and an SEC report issued in December that found no evidence of a significant negative impact of fair-value accounting.[5]

The consistency of implementation and enforcement of IFRS in jurisdictions that have adopted them may also merit the attention of the G20. Such cross-border consistency is not a given even within the European Union. The IASB is not responsible for the way its standards are implemented, and thus the question of whether there should be a form of global monitoring remains open for the moment.

Supervision of intermediaries

On the vexed question of how to oversee large and complex cross-border financial institutions, the G20 pledged in November 2008 to create or strengthen supervisory 'colleges', which bring together national supervisory authorities with jurisdiction over a specific international financial firm under the coordinating authority of (generally) the home-country supervisor. The EU has also planned to give a formal status to such colleges in the forthcoming revisions of its own capital requirements

3. Nicolas Véron, 'Fuzzy oversight will not solve standards issue', *Financial Times*, 5 February 2009.
4. At the date of writing, not all proposed members of the Monitoring Board had yet signed its charter and memorandum of understanding.
5. Securities and Exchange Commission, *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting*, 30 December 2008.

directive (for banks) and the 'Solvency 2 directive' (for insurance companies).

Unfortunately, colleges are not likely to solve the trickiest challenges posed by cross-border banks. Either they give binding authority to the coordinating supervisor or to the entire college by majority vote, which amounts to the transnational or supranational delegation of sovereignty they were designed to eschew; or they remain mere coordinating devices, useful in allowing exchanges of information and best practices (this already exists to large extent) but not bringing effective global supervision. In fact, there can be no institutional response to this challenge at the global level because, as specifically reaffirmed in the November 2008 G20 declaration, banking supervision remains a national prerogative. The same applies to non-banking financial institutions such as investment banks or hedge funds, if these are to be brought into the fold of direct and formal financial supervision.

Beyond financial institutions, however, more integrated oversight may be envisaged for some intermediaries that are difficult to regulate or supervise at a national or even regional level because of their systemic importance and degree of global cross-border integration. This is especially the case for rating agencies, which now seem bound to be formally regulated not only in the US (as has been the case, to some extent, since the 1970s) but also in the EU and probably in other jurisdictions as well. The draft legislation initially introduced in the EU illustrates the risk of regulation resulting in raised protectionist barriers or in an extension of regulatory powers on a politically unsustainable extraterritorial basis. Unlike banks, rating agencies (and perhaps also the largest audit networks) are players for which a global supervisor may be considered by the G20 – a more sustainable scenario than less integrated alternatives.

Practical Proposals for Regulatory Reform

John Eatwell

In April 2008 the G7 finance ministers, worried about growing financial turbulence, endorsed the approach to regulatory reform presented to them in a report from an eminent group assembled under the auspices of the Financial Stability Forum and including the Chairman of the UK's Financial Services Authority, the President of the Federal Reserve Bank of New York, and the Chairman of the US Securities and Exchange Commission.[1] The report began with an honest recognition of past failure: 'A striking aspect of the turmoil has been the extent of risk management weaknesses and failings at regulated and sophisticated firms.' There followed a series of detailed recommendations, the essence of which was embodied in three core themes: greater transparency, greater disclosure and stricter risk management by firms. In other words, *nothing new*. The committee was repeating the tired trinity that has defined financial regulation for the past three decades. The trinity failed, and without a new approach the regulators will fail again.

That failure had two closely related origins: regulation failed to keep up with the institutional changes that in 30 years have transformed financial markets; and the regulators accepted that firms had the technical skills, expressed in their mathematical models, to manage risk better than the regulator could.

Thirty years ago most loans to businesses and to individuals were made by banks, or specialist institutions such as building societies. The deregulatory fervour of the 1980s changed all that. Credit markets became 'disintermediated'; instead of banks acting as intermediaries between savers and borrowers, the markets took over. A significant proportion of borrowing (though still less than half) is now packaged into securities that are sliced and sold through a myriad of financial intermediaries. Investment banks, such as Lehman Brothers, Merrill Lynch, Goldman Sachs, Barclays Capital and RBS, were at the centre of this process, taking on massive amounts of debt relative to their capital base (becoming highly leveraged) in order to deal profitably in the complex web of markets. Guiding their operations were the statistical models that purported to measure the risk of their operations against patterns of past market behaviour. The firms claimed that they could manage risky markets, *and the regulators swallowed that claim*.[2] Faith in transparency, disclosure and risk management by firms is at the heart of financial regulation today. While many of the investment banks have disappeared, the same philosophy persists. Yet at the same time it is generally accepted that a core purpose of financial regulation is to mitigate *systemic* risks, such as a general loss of liquidity. Such risks are externalities; their cost to the economy as a whole is greater than the cost to a firm whose actions are creating the risk, and greater than the risk exposure of the firm as assessed by its risk models. In the face of *systemic* market failures even the most transparent market is inefficient and risk is mispriced, with consequences that are all too evident today. So what can be done to tackle 'systemic' risks?

First, regulators must base their approach on the system as a whole. For example, while financial firms are encouraged by supervisors to conduct thousands of stress tests on their risk models, few are conducted by the regulator on a systemic scale. If it is possible to have

1. 'Enhancing market and institutional resilience', April 2008, and 'Follow up on implementation', October 2008, Financial Stability Forum, Basel (www.fsforum.org).
2. 'Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief. … This modern risk-management paradigm held sway for decades. The whole intellectual edifice, however, collapsed in the summer of last year.' Alan Greenspan, evidence to US House of Representatives, 23 October 2008.

systemic stress tests on the impact of Y2K, or of avian flu, why not on liquidity? The regulator should conduct tests of scenarios most likely to produce systemic stress – such as a 40 per cent drop in house prices. The information gleaned in this exercise should feed into regulatory measures that are likely to be quite different from those suggested by the risk management of an individual firm. After all, banks end up concentrating their resources in places where their *individual* risk management systems tell them, erroneously, they are safe.

Analytically, a major unresolved question is whether it is possible to build systemic risk models 'from the bottom up', i.e. at the level of the firm but recognizing the presence of externalities and of strategic behaviour. I believe that for all practical purposes it is not possible to model financial externalities in this way, because financial externalities are predominantly macro-economic (the general state of confidence/uncertainty) and are transmitted macro-economically (the general levels of interest rates, the exchange rate, and so on). Hence, micro-risk management by individual firms should be combined with macro-risk modelling by the regulators, with consequent macro-prudential regulatory interventions based on macro-risk assessment.[3] However, as noted below, *international* macro-prudential regulation poses a number of difficult issues.

Second, as an important component of macro-risk management, financial institutions must be required to undertake procyclical provisioning, raising their reserves in good times and using those reserves as a cushion in bad times. The rules determining these reserves would be quite different from those governing the regulatory capital that financial institutions are required to hold today. That capital is a charge, not a buffer. Since the firm must hold a certain capital reserve to be allowed to operate, it cannot use that reserve to tide it over in bad times. The provisioning requirements should be based on the health of the economy as a whole, so capturing systemic strength and weakness. A policy with some of these characteristics has been pursued in Spain where, despite the massive property crisis, the banks have so far remained strong. Astonishingly, it has been proposed that the Spanish system should be dismantled because it is not in accord with international financial accounting standards.

Third, to secure effective macro-risk management, financial regulation must escape from its present focus on the nature of institutions – commercial banks are regulated differently from investment banks; hedge funds are not regulated at all – and concentrate instead on function. Major macro-risk stems from the liability side of the balance sheet. Targeting regulation on highly leveraged financial institutions, whatever their formal legal status, would be an important step in this direction. Many years ago the only significant highly leveraged institutions were commercial banks. Today, leverage is a characteristic of firms throughout the financial system, whether they are deposit-taking banks, investment banks, hedge funds, mutual funds, private equity firms or insurance companies. It is this leverage that threatens market gridlock in a disintermediated financial system.[4] Regulation must switch from an institutionally defined approach to a functionally defined approach as a vital component of systemic regulation.

Fourth, it would also be useful to distinguish short-term-funded leverage from arrangements with longer-term funding. Consider, for example, the current debate over the impact of mark-to-market accounting. From a risk management perspective, the problem with the current value accounting rules is that the focus is on the asset: its perceived liquidity and the intention of the asset holder to hold it to maturity or to trade it. We have seen how asset liquidity and holder intentions can change rapidly in a crisis, leading to an increasingly artificial view of value and solvency. It would be far better to focus on the *funding* liquidity of the asset. Where assets are funded with short-term liabilities, then whatever the perceived liquidity or intentions of the asset owners, it is

3. The need for macro-prudential regulation is a theme of the lecture given by Adair Turner on 21 January 2009, 'The Financial Crisis and the Future of Financial Regulation', www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0121_at.shtml, and of the draft report by Markus Brunnermeier, Andrew Crockett, Charles Goodhart, Martin Hellwig, Avinash Persaud and Hyun Shin, *The Fundamental Principles of Financial Regulation*, Geneva Report on the World Economy 11, CEPR, London, 6 January 2009.
4. There is no such thing as safe leverage. It's simply that some is safer than others.

appropriate to mark the value of that asset to market in case funding dries up and the assets need to be sold tomorrow. But where assets are funded with or set against long-term liabilities, as is typically the case with a young pension fund, then marking asset values to market is not appropriate and can lead to an artificial view of risk and investment decisions based on a risk that is not important to the holder. Indeed, an incentive to match assets and liabilities would remove much of the sting from mark-to-market accounting.

Fifth, the systemic risks inherent in the misuse of the credit derivatives markets should be addressed by developing common standards and effective clearing.[5] The prevalence of custom-made over-the-counter (OTC) contracts greatly increases the complexity of the market in credit default swaps, a complexity yet further increased by the practice of writing derivatives on derivatives. (Note that the problem is *complexity*, not *transparency*. Typically a derivative product is fully documented. The problem is that so many products are so complex that total transparency does not result in understanding.) The introduction of standardized contracts would reduce complexity and greatly facilitate the establishment of a clearing mechanism. There are around $55 trillion of credit default swap contracts outstanding today, but once back-to-back contracts have been netted out the remaining risk is less than 10 per cent of that number. Establishing a clear distinction between regulation of standardized contracts that are readily understood and relatively easily netted (requiring an effective settlement mechanism too) and complex OTC contracts would greatly reduce the downside systemic risk. The development of market-traded instruments would be encouraged if commercial banks were not permitted to deal in OTC contracts.

Sixth, given that a detailed knowledge of the operation and structure of firms and markets is essential to the effective management of systemic risk, it must be recognized that that knowledge is spread between different regulators, whether between the Financial Services Authority (FSA) and the Bank of England as in the UK, or between the large collection of regulators in the US. There is a need for all regulators to understand the interaction of market structures, and to be sensitive to the relationship between those structures and systemic risk. Why not create in the US a new overarching Federal Regulatory Commission, the membership of which spans all relevant regulators, who would thus be jointly and severally responsible for financial stability? In the UK the FSA and the Bank of England should create a common Financial Stability Committee, guiding the joint responsibility of the two institutions for systemic risk. Such structures would have the dual advantage of informing stability analysis with the actual operations of disintermediated markets, and ensuring that systemic risk became a basic tenet of the operational philosophy of all regulators. These overarching committees should be backed by well-resourced research departments. As the experience of the past year has shown, it was only the lowly research teams that spotted the dangers of sub-prime mortgages. They were ignored. They now need a voice at the top table.

Finally, effective regulation requires that the domain of the regulator be that of the market being regulated. In today's liberal financial markets, this means that effective regulation must be international.[6] The G20 will need to construct an operational counterpart to the Financial Stability Forum that can monitor, coordinate and if necessary enforce measures in individual jurisdictions. It has been suggested that the International Monetary Fund, as an existing treaty organization, could fulfil this role. I am not convinced this would be the best approach, since what is needed is an organization that has a new sort of relationship with the authorities in systemically relevant countries. However, it may be necessary to fall back on the IMF if the consensual approach of the Basel committees is deemed inadequate, and the complexities of creating a new treaty organization prove excessive. Perhaps a new organization embedded within the IMF is the answer.

5. To be fair, this was also in the Financial Stability Forum reports cited in note 1 above.
6. The case for an international regulator is made in John Eatwell and Lance Taylor, *Global Finance at Risk: The Case for International Regulation* (New York: The New Press, 2000).

But even if the institutional problem is solved, the extension of macro-prudential regulation to international markets, and especially to internationally active firms, poses a major problem. If the economic (and financial) cycles of the major economies are not highly correlated, then 'dampening' actions in one jurisdiction may be offset by 'expansionary' actions in another, encouraging potentially destabilizing 'macro-prudential regulatory arbitrage'! The answer to this dilemma probably has to be a pragmatic one: if cycles are not correlated, potential problems are less severe than they otherwise might be. And in so far as macro-prudential regulation has a dampening effect in booms and an expansionary effect in slumps, the overall international position is not likely to be destabilizing – just so long as everyone sticks to the rules.

Financial Regulation: Three Steps We Can Take Now

Robert Rosenkranz

An international, cooperative approach to financial regulation in the aftermath of the crisis might usefully focus on three initiatives. First, rating agencies have become the *de facto* allocators of capital, because regulators have put the power of law behind their judgments. Poor judgments about structured securities resulted in misallocations of credit to house finance and an ensuing house-price bubble, the root cause of the current crisis. Rating agencies should be written out of our laws, and the capital rules applicable to financial institutions should rely instead on market spreads rather than ratings to assess risk.

Second, credit default swaps (CDS) were, at their peak, a $60 trillion market, dwarfing the $6 trillion of US corporate debt outstanding. CDS serve a useful economic function, but they created the potential for contagion among leading financial institutions. We should mandate that CDS trading take place on regulated exchanges, with standard margin provisions, transparent price and volume data, safeguards against manipulation, and a centralized clearing mechanism.

Third, Generally Accepted Accounting Principles (GAAP) have become highly procyclical in the past decade, particularly with the emergence of such concepts as 'fair value' accounting and mandated losses on 'other than temporary' impairments. Both US GAAP and International Accounting Standards are formulated by boards, staffed by accountants, whose goal is to maximize the utility of accounting statements to their users. They generally lack the training or expertise to consider the larger implications of accounting principles for the functioning of financial firms and markets, and the broader economy, as they move through inevitable cycles of expansion and contraction. We should take a lesson from the US insurance industry, and establish regulatory accounting principles (RAP) for banks, insurance companies and other regulated financial firms. RAP, rather than GAAP, should determine capital adequacy.

These three problems have interacted in a particularly toxic way in the current crisis. The AIG saga is an interesting case study. AIG assumed credit risk on too many highly rated securities whose risks they misjudged, in part because regulatory capital requirements pushed them in that direction. When the risks began to emerge and liquidity in credit markets dried up, market snapshots drove reductions in equity and earnings. AIG's CDS exposures were huge, in part because they were not exchange-traded and hence had no associated margin requirements. AIG's counterparties were thus at risk, but were satisfied as long as AIG held an AAA rating. The emerging mark-to-market losses jeopardized that rating, leading to cash demands from CDS counterparties that AIG could not fund. The systemic risks were such that government intervention was needed.

Elements of the same story apply to most of the major financial institutions presenting systemic risk. The initiatives suggested here will not fix the current crisis, but they do address root causes and should substantially mitigate the chances of a recurrence.

Rating agencies

The ratings agencies have been widely criticized for their role in the financial crisis. It is said that they wrongly assessed the risks on trillions of dollars backed by residential mortgages. And indeed they did. But the real problem was not the erroneous ratings *per se* (everyone misgauges risk and the ordinary mortals in ratings agencies are no exception), but the fact that these erroneous ratings were incorporated into law. The capital requirements for US financial institutions are highly sensitive to the ratings of the bonds they hold. Money market funds are typically barred altogether from investments rated lower than AAA. The Bank for International Settlements (BIS) also uses ratings to drive capital requirements, so the rating agencies have the same role in global capital markets. This regulatory approach creates a massive incentive to group and slice assets in ways that maximize not their fundamental soundness but their rating.

Indeed, that is the principal *raison d'être* of the $6 trillion structured finance industry. Sub-prime mortgages (and all manner of other risky loans) held directly by financial institutions are questionable assets with high associated capital charges. Each one alone would deserve a 'junk' rating. Structured finance simply piles such risky assets in bundles and slices the bundles into tranches. The rating agencies deemed some 85 per cent of the tranches, by value, AAA credits, and nearly 99 per cent investment grade, thus turning dross into gold by a sort of ratings alchemy.

This ratings alchemy created enormous demand for dross, in this case dodgy mortgages. Credit was extended to countless dubiously qualified purchasers of homes, which in turn drove dramatic increases in house prices. The housing bubble has now burst, with average house prices in America down some 20–25 per cent from the peak. This led to the current crisis, which is potentially the most severe economic downturn since the Great Depression.

President Barack Obama and the US Congress should write ratings agencies out of the law forthwith, as should the BIS. The market is a far better judge of risk and value than any individual analyst, team, or firm. The amount of capital required to hold a fixed-income security should be determined not by a rating but by its yield, expressed as a spread over treasuries. The higher the spread, the riskier the market has determined the asset to be, and the more capital should be required to hold it. Similarly, financial institutions should be required to set aside a percentage of their interest income every year as reserves for credit losses; the higher the spread, the higher the reserve percentage. Should spreads widen, the share of the return set aside for reserves should increase, thus gradually increasing reserves commensurate with the market's perception of increased risk.

Credit default swaps

A credit default swap passes the risk of a default by a corporate borrower from one party to the swap to the other. Total CDS outstanding at the peak were roughly $62 trillion, twelve times the amount of actually outstanding corporate debt. Thus a corporation defaulting on $5 billion in debt triggers payments on CDS contracts of more than $60 billion. Obviously any market this big can destabilize the system. Yet there is not even the most rudimentary regulatory framework for transparency: no data on volume, no data on transacted prices, no central marketplace, no calculation of net outstanding positions, no capital requirements for market participants, no official mechanism for settlements, and no restraints on manipulation. CDS are an inventive and useful element in a free-market economy, but they entail the risk that the failure of a major financial institution such as AIG can cause a contagion affecting all the other major players.

CDS also make it very easy to speculate against individual debt issuers. Bearish investors are essentially unconstrained in driving spreads up by effectively selling short the credits of individual issuers. For financial institutions, this can easily become a self-fulfilling prophecy, as the higher spreads drive their costs of capital up and their earnings down, in a vicious cycle terminating with a 'run' in which their liabilities cannot be rolled over at any price.

Another feature of the over-the-counter CDS market is that margin requirements are not driven by daily price changes but by the ratings of the counterparties. Ratings downgrades thus become highly destabilizing events – self-fulfilling prophecies themselves – as we saw in the case of AIG.

All of these concerns can be effectively mitigated by normal exchange trading arrangements. As is the case in commodities and futures exchanges, all participants would have initial and maintenance margin requirements, thus limiting counterparty risk to a single day's trading. A central clearing mechanism would also minimize counterparty risk and hence the danger of contagion if a single major participant fails. The ratings of market participants would be irrelevant. Prices, volumes and open interest would be reported, bringing transparency both to the market as a whole and to the regulators.

Rules against manipulation are also critical. Those who purchase CDS on bonds they own are hedging their risk; those who purchase CDS on bonds they do not own are seeking a speculative profit in the event of default. Speculators should have substantially higher margin requirements than hedgers, and should be subject to the equivalent of a down-tick rule for stocks, which requires that short sales be executed at prices equal to or higher than the previous trades. This would reduce their ability to trigger the very defaults they seek to profit from.

GAAP accounting

In prior credit and interest rate cycles, major financial institutions were often insolvent in the sense that they could not liquidate their assets for more than the face value of their liabilities. This state of affairs was disquieting, of course, but as long as the institutions could operate as going concerns and roll their liabilities over in the ordinary course of business, disquiet did not breed disaster. There was no 'run on the bank' forcing the sale of assets at distressed prices at cyclical lows. Indeed few, if any, financial institutions could survive a 'run on the bank' at any time. That is why we have the Federal Deposit Insurance Corporation (FDIC), the Securities Investor Protection Corporation (SIPC), and state guarantee funds to insure the obligations of banks, brokerage firms, and insurance companies respectively. These institutions protect the customers of failed financial enterprises, but far more importantly they prevent concerns about their solvency from becoming self-fulfilling prophecies.

'Fair value' or mark-to-market accounting does the opposite. At the time of greatest fear in the markets (and cycles of greed and fear in markets have been with us since Babylonian times) a handful of the weakest holders of assets may sell in panic, or be forced to sell by their creditors, into highly illiquid markets. The 'market prices' thus established are then used by the accountants, either directly or as an input into a 'fair value' process, to value similar assets held by financial institutions generally. Consider that in December 2008, the average of the top 100 bank loans were selling at 65 cents on the dollar, implying that the holders had lost 35 cents. A quite draconian estimate of ultimate credit losses on these loans is 8–12 per cent (20–30 per cent defaults, with 60–70 per cent recoveries). Credit losses of that magnitude will be a strain for banks, hurting earnings and weakening capital positions for several years. But only the weakest banks will be unable to cope. What 'fair value' accounting does is not to recognize 8 or 12 cents of losses over a period of several years, but to recognize 35 cents of losses as an immediate reduction in equity. There follows a determination, driven by the imprecise language in the accounting pronouncements, as to whether such losses are 'temporary' or 'other than temporary'. If losses are deemed 'other than temporary' they are treated as if the securities had been sold at a loss for purposes of both stating income and calculating statutory capital. This accounting principle is why so many major financial institutions appear weaker now than they did in previous cycles. The appearance of weakness becomes a self-fulfilling prophecy, generating pressures to shrink lending, to delever balance sheets, and to raise capital on terrible terms. Financial cycles are like motion pictures, with scary bits followed by happy endings. The quarterly marks are like snapshots, taken at the most unflattering moments. When the snapshots dominate, there may be no happy endings. I am not suggesting that such snapshots be torn up – simply that they belong in footnotes to financial statements, to be considered as the users see fit, rather than as prime drivers of the balance sheets and income statement.

Accounting principles are formulated, both in the US and internationally, by accounting standards boards, generally staffed by members of the accounting profession. They view their role as maximizing the utility of financial statements to the user. They do not systematically consider the larger implications of accounting principles on the functioning of markets or the broader economy, nor are they equipped by training or expertise to do so. When the authorities bring these considerations to bear, the Financial Accounting Standards Board (FASB) is often resistant. Recently, in the Emergency Economic Stabilization Act (EESA) legislation, Congress recognized the problem and authorized the Securities and Exchange Commission to suspend mark-to-market accounting. The SEC demurred, but did urge more flexible application of the existing rules. The FASB responded grudgingly, with some modest changes, which the pricing groups within the 'big four' accounting firms[1] watered down even further in practice. Thus it is hard to imagine that accounting standards established under current mechanisms can ever serve larger policy and strategic goals adequately.

Congress has already given the SEC authority to suspend mark-to-market accounting, and the International Accounting Standards Board has made some movement in that direction. The US should go further and lead a co-ordinated suspension of this rule. By doing so, it would buy, at very low cost, some badly needed breathing room for the financial sector. There is a risk that a suspension of mark-to-market rules will be perceived as a denial of reality. That risk should be mitigated by a far more rigorous set of standards to gauge reserves for credit losses, and to verify their adequacy. The property and casualty insurance industry is a good model: it routinely establishes reserves for unknown future events. Those reserves must pass muster with professionally certified internal actuaries, with external independent actuaries, with the actuarial departments of independent audit firms, and with state insurance regulators. This approach – a focus on the adequacy of reserves for ultimate losses on assets, rather on than their price in a chaotic and illiquid market – treats financial institutions like going concerns and helps ensure that they remain so.

1. PricewaterhouseCoopers, Deloitte Touche, Ernst & Young and KPMG.

Principles for Financial Supervision Reform

Robert Nichols

The G20 meets in London at a time of unprecedented challenge, and its decisions and subsequent actions will have long-lasting implications for its member nations and, indeed, the world.

Among the challenges the G20 must take up as part of its efforts to address the global economic downturn is reform and modernization of financial supervision – both at the national level and with the aim of improving cross-border cooperation. Financial markets are global and so are financial crises. The current crisis is complex in nature and origins. Sorting out how it happened and ensuring it never happens again are complicated tasks that require time and careful thought. It is already widely acknowledged, however, that outdated supervisory frameworks helped create the opportunity for the crisis.

As part of the broader reform effort, in recent months the Financial Services Forum (FSF)[1] has been working to develop principles that it believes should define the parameters of meaningful reform and modernization of financial supervision in the United States. The current framework is a Depression-era patchwork of regulatory fiefdoms with overlapping jurisdictions, varying statutory responsibilities and powers, and often inconsistent supervisory postures, priorities and methodologies. These circumstances have led to regulatory arbitrage and inefficiency. Unfortunately the balkanized nature of the current framework undermines regulators' ability to ensure institutional and systemic safety and soundness.

The United States needs a 21st-century supervisory framework that ensures the safety and soundness of all financial institutions and the financial system as a whole; that protects the varied interests of depositors, savers, investors and policy-holders; and that is responsive to the activities, innovations and risks of the world's most dynamic capital marketplace.

Forum principles of financial supervision reform

Ensure the stability of the US financial system and the safety and soundness of all financial institutions operating in the US. 'All financial institutions' would include conventional financial institutions as well as non-conventional (i.e., hedge funds, private equity firms) that pose systemic risk. A systemic supervisor should be established to oversee the financial system in totality, ensure comprehensive oversight of all financial institutions, and provide a mechanism for greater regulatory cooperation and consistency – all of which would serve to ensure systemic stability and the safety and soundness of all financial institutions.

Protect the legitimate interests of varied financial institution stakeholders including depositors, customers, investors and policy-holders, while being mindful of the cost to taxpayers and intergenerational debt burdens. The interests of depositors, customers, investors and policy-holders can vary and their protection may require a degree of regulatory specialization.

Make regulatory oversight more accountable, effective, responsive and efficient through material supervisory rationalization and the elimination of unnecessary supervisory overlap and duplication. Supervisory overlap and

1. The Financial Services Forum is a non-partisan financial and economic policy organization comprised of the chief executive officers of 17 of the largest and most diversified financial services institutions doing business in the United States. The purpose of the Forum is to pursue policies that encourage savings and investment, promote an open and competitive global marketplace, and ensure the opportunity of people everywhere to participate fully and productively in the 21st-century global economy.

duplication have led to confusion, regulatory arbitrage, structural imbalances, inefficiency and waste, as well as undermining regulators' ability to ensure institutional and systemic safety and soundness. Howell Jackson of Harvard Law School has estimated that gross financial regulatory costs to US taxpayers – even after adjusting for differences in GDP – are more than six times greater than in the United Kingdom. Other industry experts have estimated that regulatory costs to American financial institutions are fifteen times higher than in the United Kingdom. No doubt most of this burden is the result of substantial supervisory overlap and duplication.

Ensure that all financial institutions are subject to comprehensive oversight (i.e. covering all aspects of a firm's varied businesses and the associated risks). It is widely acknowledged best practice that all financial institutions – particularly large and complex financial conglomerates – should be subject to 'comprehensive consolidated supervision', whereby some supervisor, either directly or relying on functional regulators for subsidiary-specific information, understands and is familiar with the details of all business activities and the associated risks of a financial enterprise.

Ensure that any federal oversight of financial institutions takes into account the varied nature of the business operations of each type of financial institution and that the expertise needed to provide effective oversight is present. Notwithstanding tremendous convergence in recent decades of previously distinct financial sectors and the products and instruments they develop, market, and deal in, sufficient sectoral differences remain that warrant an appropriate degree of regulatory specialization and expertise.

Ensure 'umbrella' or 'systemic' oversight of the financial system as a whole, and improve supervisory cooperation, consistency and transparency among financial institution regulatory authorities. Regulatory inconsistencies across industry sectors, insufficient regulatory cooperation and a stovepiped regulatory structure – no authority looking at the big pictures – all contributed to the current crisis. A more seamless, consistent and holistic approach to supervision is necessary to ensure systemic stability and the safety and soundness of all financial entities.

Ensure a 'level playing field' – institutions developing, marketing and dealing in similar products and services entailing similar risks should be subject to similar supervisory oversight. Recent decades have witnessed tremendous convergence in the activities, products, instruments and associated risks of previously distinct sectors of the financial marketplace. Differences in regulatory treatment cause confusion, introduce structural distortions and encourage regulatory arbitrage – all of which undermines safety and soundness.

Improve financial market transparency by requiring greater disclosure of more reliable and relevant financial information by all financial institutions to market participants. Markets run on information – more reliable and relevant information improves pricing and market performance, minimizing distortions that can lead to crisis. Among the many goals of enhanced regulatory cooperation, greater disclosure and transparency should be a top priority.

Enhance cross-border supervisory cooperation and the harmonization of regulatory methodologies and requirements internationally. While sovereign states and national jurisdictions still matter, financial markets are global and so are financial crises. Harmonization of international supervisory and accounting standards, greater information-sharing, and more frequent and robust cross-border cooperation will greatly enhance the effective and efficient functioning of global capital markets, as well as official crisis response efforts.

Integrate rules-based regulation with overarching principles of prudential supervision. Much of the discussion regarding 'rules-based' vs 'principles-based' supervision is erroneous and misleading – as if policy-makers must choose between the two approaches. Overarching principles are critical to effective, well-reasoned supervision, as are rules for implementing those principles. Proper integration of principles and rules should be the objective.

Change can be difficult and can cause significant anxiety – even when virtually everyone agrees it is necessary and overdue. But reform and modernization of US financial supervision is possible and desirable. For decades the US financial system has remained the world's leader despite the costs, burdens and deficiencies of an outdated supervisory framework. The United States can no longer afford such a significant competitive drag and threat to safety and soundness.

By preserving the diffusion of regulatory power while achieving significant rationalization and a much more efficient, consistent and comprehensive supervisory framework, the Forum's principles for supervisory reform and modernization strike the balance between the strengths of the current framework and badly needed, long-overdue reform. As a result, the safety and soundness, and the competitiveness, of the US financial system (and thus the global capital markets) would be greatly enhanced – and investors and depositors would have the protection and peace of mind they deserve.

Toward a Global Regulatory Framework for Credit Ratings

Standard & Poor's[1]

Overview and summary

Our financial markets have changed radically in recent years, becoming more global, complex and interdependent. Clearly, laws and regulations have to change as well, and world leaders are making good progress toward creating a new global financial architecture. The need for change includes the regulatory framework for credit rating agencies in the US, Europe, Asia and the rest of the world. Rating agencies play an important role in the market's analysis of the creditworthiness of issuers and financial instruments. Investors also use rating opinions as a tool in making investment decisions – although it is important for investors to realize that ratings are only one tool, and they should not be used as a substitute for independent investment analysis.

For its part, Standard & Poor's Ratings Services (S&P) is reflecting on what more should be done in the future. It is clear that a number of the assumptions credit rating agencies used between 2005 and 2007 in rating structured finance bonds backed by sub-prime mortgages have not held up. One unforeseen development was the extreme nationwide collapse in the US housing market. Rating agencies and others, including banks, insurance companies, regulators and policy-makers, did not anticipate the full extent of what has become a global recession, fuelled by the implosion of the unregulated derivatives market, loose monetary policy, excessive liquidity and record levels of institutional and personal debt.

Going forward, it is important to the restoration of confidence in the markets that all market participants take stock of what has happened and adopt workable solutions. At S&P, we have been actively applying lessons from the current crisis to adopt a number of constructive measures. We will continue to do so. We also believe regulation can play an important role in this process, and we welcome proposals that would, on a globally consistent basis, increase transparency and preserve the analytical independence of rating agencies' opinions and analytical processes. This paper is offered in a spirit of cooperation and openness to promote independent, credible ratings, and to foster investor confidence in the capital markets.

This paper provides S&P's recommendations for what regulations should accomplish generally, as well as specific recommendations that should be instituted globally for credit rating agencies, keeping in mind the necessity of restoring investor confidence and ensuring a fair playing field for investors. It also considers the current use of ratings in regulations and investment guidelines.

The goals of regulation generally

The current financial crisis has prompted a number of questions about both the regulation of credit rating agencies and the financial regulatory system in general. In large part, the current regulatory structure reflects the fragmented state of the markets from nearly 70 years ago, when banks, securities firms and insurance companies engaged in distinctly different activities. Today, many of the products and services offered by these financial firms have converged, yet the entities that regulate them and the rules under which they operate remain largely distinct. Regulators find that their jurisdiction does not match the

1. This paper was presented by Rita Bolger at the ACUS–CH workshop on 2 March 2009. It has been published as a White Paper by Standard & Poor's – http://www2.standardandpoors.com/spf/pdf/media/GlobalRegReport.pdf.

activities of the entities they are regulating. At the same time, new, unregulated players have entered the scene, and products have been developed that fall outside the existing regulatory process. These developments suggest the need for reform of our financial regulatory architecture. Entities that have been unregulated may require regulation, and some regulatory bodies may require their mandate to be widened to reflect changes in the activities of the entities they regulate. Recent US Government Accountability Office and G30 group reports call for clearly defined regulatory goals that are global, system-wide and comprehensive, addressing all roles and processes and taking a flexible approach.

S&P believes any new regulatory architecture should focus on the following goals with regard to credit rating agencies and others:

- Safety and soundness of financial markets;
- Business conduct based on transparency and fair dealing;
- Efficiency and cost-effectiveness by aligning responsibilities among different participants across the marketplace;
- Consistency of regulation across similar businesses;
- Internationally consistent standards and coordinated enforcement;
- Adaptability to accommodate future innovations and changes in market structure;
- Flexibility to foster fair competition to benefit investors;
- Promotion of credit ratings that are analytically sound, independent, and unbiased; and
- Promotion of competition among rating agencies and differing views on creditworthiness.

The general goals of regulation of credit rating agencies

S&P believes that well-crafted regulation of credit rating agencies can serve to meet the goals of regulation as described above. It can also serve to enhance the ratings process and restore investor confidence by facilitating consistent application of practical and flexible standards. While regulation should avoid dictating how a rating agency should go about performing its analysis, ultimately a well-functioning ratings process offers benefits for the economy as a whole by contributing to greater investor confidence.

In order to address areas where investors and policy-makers have identified gaps and key issues in the current regulatory regime for credit rating agencies, we have highlighted below the significant investor concerns and expectations we have heard and how regulation might enhance the process.

1. Independently derived, credible, and unconflicted credit ratings. Appropriate regulation that addresses the effective management of potential conflicts of interest can only benefit the marketplace. This is an area where regulation can be particularly helpful by requiring policies and procedures to address potential conflicts of interest at the institutional and staff levels, including a code of ethics that requires disclosure of potential conflicts, how they are managed, with oversight of the code's effective application for all rating agency business models. Regulations could also prohibit activities that are clearly anticompetitive.

2. Transparency regarding issuer and rating agency communication. Market participants want to know about the interaction between issuers and analysts during the rating process, particularly where issuers request a structured finance rating.

3. The meaning and use of ratings should be clear, including the level of risk inherent in the rating. Rating agencies that are transparent about the meaning and limitations of their ratings – for example, clarifying that credit ratings do not address the suitability of a security for any individual investor – are of use to the market. Regulation that requires rating firms to provide publicly detailed explanations about the nature of their opinions and pertinent information used in the rating process would enhance investor knowledge, as would regulation that encourages rating agencies to commit to ongoing investor education.

4. Consistency and comparability of ratings across asset classes and geographies – accountability for ratings

quality. Regulation that requires rating agencies to publicly disclose their ratings performance statistics would aid market participants in assessing ratings quality. Rating agencies can be subject to appropriate and proportionate penalties in cases of proven breaches of regulatory requirements.

5. Transparency and soundness of credit rating analysis. Regulation that requires robust disclosure of the ratings process, including criteria and methodologies for assigning and updating ratings, would give investors critical information they need to make informed decisions, to compare ratings, and to form their own opinions on the soundness of an agency's analytics. A similar result could be achieved through regulation that requires identification of the models and underlying assumptions used in a rating agency's analysis. There is a particular need to identify such models and assumptions in structured finance. In addition, regulation that requires agencies to publicize their ratings performance statistics and allows for comparison across geographies, certain asset classes and with competitors, would inform independent investor analysis. Rating agencies could add to this informational process by making personnel available to explain their methodologies to users.

6. Clear and consistent applications of policies to lessen 'surprises' when and if ratings are changed. Rating agencies that use 'warning signals' whenever possible – such as S&P's CreditWatch and Outlook signifiers – to signal to the marketplace potential future rating changes are important to investors. However, rating users need to understand that ratings can change suddenly based on market- or industry-specific events. This possibility is a reason why regulators might carefully reconsider using ratings exclusively in their regulations.

7. Ratings on new and different securities should be differentiated. The current financial crisis has highlighted the need for markets to better understand the meaning of ratings on new and complex securities, including structured finance ratings, and how they differ from traditional ratings. Regulation could play a role in making those differences transparent.

8. Availability of information, particularly for structured finance ratings. Rating agencies that utilize the issuer-pays model receive confidential information from issuers and others throughout the rating and surveillance process. Regulation that requires agencies to follow policies and procedures to avoid the disclosure and misuse of confidential information would be consistent with the spirit of current securities regulation. Where markets and regulators believe the confidential information should be made available to a rating agency's competitors or to others, regulation should require issuers and others responsible for the quality of that data to make this information widely available.

9. Confirm that rating agencies are following through on their commitments. Regulation that provides for regulatory authorities to check agencies' compliance with their processes and policies through robust, periodic inspections would be beneficial to promoting ratings quality. However, regulators must protect analytical independence by avoiding rules and examination processes that impact on the substance of rating opinions and an agency's analytics.

10. Competitive market for ratings with more and varying views on credit quality from qualified providers. Ratings based on a high degree of integrity and intellectual rigour benefit the marketplace, and formal registration of credit rating agencies and promotion of increased industry competition should help in this area. A registration regime that follows globally consistent standards can serve as a model. Regulators that are transparent about the criteria they use in accepting applications, including the need for sufficient analytical and financial resources, would act as a uniting force in establishing a global regulatory framework. Regulation that requires disclosure about staffing, number of ratings issued, and training requirements would allow regulators to make more informed decisions regarding the adequacy of an agency's resources. Regulators could also increase their ability to evaluate agencies by analysing financial information from agencies provided to regulators on a confidential basis. Regulators should be careful, however, not to attempt to supplant their own judgments about ratings analysis for those of independent rating agencies. Evaluations as to the quality of ratings and ratings processes should ultimately be left to the market.

Specific recommendations for an international regulatory framework for credit rating agencies

Credit rating agencies conduct business in numerous countries across the globe. A regulatory framework that provides consistent standards across jurisdictions can promote the soundness of international, as well as domestic, business.

One potential model for an international regulatory approach is the IOSCO Code of Conduct, recently updated in May 2008. For example, in the US, credit rating agencies are subject to the Credit Rating Agency Reform Act of 2006, which sets standards that to a significant degree mirror those established under the IOSCO Code of Conduct.

Regulators in Europe, Japan and Australia are actively reviewing formal oversight of rating agencies. Regulators in any country should take care before seeking to exceed existing standards given the effect such an approach could have on rating agencies operating in multiple jurisdictions. These agencies may face conflicting rules that could ultimately harm ratings consistency owing to country- or region-specific requirements.

A sound regulatory framework for rating agencies globally should have the following components:

Registration. One feature of a globally workable regulatory regime would be to have rating agencies register in the jurisdiction of their principal place of business and only allow registration of those that have in place standards to promote ratings integrity. From its home jurisdiction, a rating agency could be recognized to do business in other jurisdictions pursuant to a notice filing with the local regulator. This 'passport' would allow for a streamlined and consistent regulatory approach across all the jurisdictions in which the credit rating agency conducts business. Regulators could consider limiting regulation to agencies whose ratings are used in local laws or regulations.

Performance measurement. Another feature would be to require registered rating agencies to publicly issue performance measurement statistics over the short, medium, and long term, and across asset classes and geographies.

Disclosure of rating methodologies. Registered credit rating agencies could also be required to make robust disclosures regarding the analytical bases of their ratings opinions, the type of information used to arrive at ratings, and their internal standards for promoting consistency and for monitoring and updating ratings. With greater transparency of credit rating agency methodologies, investors would be in a better position to assess the opinions.

Control over non-public information and disclosure of underlying data. By having access to non-public information, rating agencies are in a position to provide more informed analysis, thus potentially enhancing the quality of the ratings they provide. Accordingly, any regulatory regime for credit rating agencies should ensure that agencies have policies and procedures requiring their employees to treat non-public information confidentially. Regulators should understand that, if such information is disclosed to a rating agency, including to rate a structured finance product, the responsibility for the quality of the information provided and the disclosure to the marketplace in a broad and fair manner rests with the issuer and the underwriter. Regulators should consider whether compulsory disclosure by issuers and underwriters of confidential information would be more efficient and beneficial to the marketplace. Such rules would allow competing agencies and sophisticated market participants to evaluate in greater detail the analysis and assumptions of the rating agency.

Organizational transparency. Registered credit rating agencies should be required to disclose detailed information about their organization's structure, including their resources, their independence from any particular issuer, their ability to train and retain employees, and the independence of commercial from analytical functions. Rating agencies should provide pertinent information about their financial resources to regulators on a confidential basis.

This disclosure will allow regulators to assess the viability of agencies.

Development of code of ethics. Rating agencies should develop and disclose to the public a detailed code of ethics, including a description of how that code will be enforced and how it relates to broader principles such as existing industry or regulatory standards. An independent officer or ombudsman should be established to communicate with the public regarding concerns that might arise about the code's enforcement.

Elimination of potential conflicts of interest. A regulatory regime must include robust standards for analyst and employee independence and the procedures for mitigating potential conflicts of interest in the ratings process. Regulation should require disclosure of such conflicts and prohibit analysts from performing commercial activities and providing consulting or advisory services to entities they rate. In this regard, regulation should require disclosure of the guidelines for analyst and issuer interaction. Regulation should prohibit analysts from being compensated based on the fees paid by the entities they directly rate.

Prohibitions on anti-competitive activity. A regulatory regime should prohibit unfair, abusive or coercive activity. Certain activities should be prohibited outright, such as threatening an issuer with an unfavourable rating or threatening to withdraw an existing rating unless the rating agency is paid to rate an issue.

Transparency of models. A regulatory regime should require policies and procedures on the use and transparency of models, assumptions and how agencies check their effectiveness, including through the use of third parties.

Accessibility. A regulatory regime should require a mechanism for ratings users to raise questions about methodologies and should require registered credit rating agencies to have in place personnel to answer these questions.

Effective oversight. A regulatory regime should provide for effective oversight of registered agencies' compliance with their policies and procedures through robust, periodic inspections. Such oversight must avoid interfering in the analytical process and methodologies, and not second-guess rating opinions. External interference in ratings analytics undermines investor confidence in the independence of the rating opinion and heightens moral hazard in influencing a rating outcome.

Analytical independence. Regulators must preserve the analytical independence of rating agencies' opinions, analytical processes and methodologies. This independence is critical to restoring confidence in credit ratings and fostering innovation in financial services.

Accountability. A regulatory regime should hold registered rating agencies accountable for established breaches of the regulations without undermining analytical independence. Sanctions may include penalties proportionate to the nature and seriousness of any breach, suspending or removing an agency's registration, and disallowing the continued use of that agency's ratings for regulatory purposes.

International consistency. Regulatory regimes globally must be consistent in applying standards. Regulators should coordinate in exercising oversight of rating agencies subject to regulation beyond their own borders. This will avoid inconsistent rules and inconsistent handling of infractions that would create uncertainty for analysts and users of ratings. Regulators should commit to sharing information, subject to confidentiality undertakings.

Meaning of ratings. Rating agencies should clearly explain the meaning of their credit ratings and what elements they do not address: for example, suitability of investments for any particular investor.

Differentiate new and complex ratings. A regulatory regime could require that new and complex ratings, including structured finance products, be differentiated in some manner to put investors on notice that potential volatility or the types of underlying assets/data for rating structured products may be distinguishable from factors affecting corporate and municipal ratings.

Use of ratings in regulations

The use of ratings in regulations and investment guidelines has been debated in global markets. We believe that if regulators and policy-makers choose to incorporate ratings in their rules as benchmarks to measure creditworthiness, then the use of additional benchmarks may also be warranted. There may be additional appropriate benchmarks for market participants to choose from – whether in regulations, investment guidelines, or private agreements – that would protect against 'credit cliffs', namely situations when rating downgrades can occur quickly and without forewarning. Where regulations mandate minimum rating levels, credit cliffs can cause market disruption and significantly impair the liquidity of downgraded securities.

Regulation of other market participants

Ratings play only one role, among many, in the investment decision-making process. Others, such as auditors, play a unique role that rating agencies should not be expected to play because that would add unnecessary costs and inefficiencies to the system. Regulation should address the role of various market participants such as mortgage lenders and originators in addition to the role of rating agencies.

Conclusion

This is a broad outline of a general approach to regulation of credit rating agencies and offers some specific suggestions for an international regulatory approach for credit rating agencies. It provides a framework for addressing the regulatory challenges of a global, fast-paced, rapidly changing market in which new financial instruments, products, markets and participants are constantly emerging, the status quo is constantly changing, and market participants have little time to assess the impact of any change. An agreement in principle on this type of framework would open the path for further work aimed at developing more specific provisions.

But no aspect of the marketplace can be reviewed or regulated in isolation. Regulators and lawmakers should also review their regulatory regimes for all market participants. The current global financial crisis calls for a full and transparent review. No doubt the structure put in place in the coming months will set the foundation for oversight of a broad array of financial market participants for years to come. S&P looks forward to assisting regulators and policy-makers in crafting fair, effective and transparent regulation that will serve our global markets going forward.

2. G20 Working Group Issues: Role of International Institutions

This section looks at reform of global economic governance, assessing the remit of G20 Working Group III: 'Reforming the IMF/International Financial Institutions' and Group IV: 'The World Bank and other Multilateral Development Banks'.

Executive Summary

Brian Henderson

The deterioration of the global economy has intensified and accelerated discussion about the role of the international institutions which govern the global economy. The IMF's role as a global stabilizer has been reinvigorated as economies facing acute balance-of-payments difficulties have required intervention. The Financial Stability Forum (FSF) has suddenly been propelled to the forefront of international mechanisms to promote coordination and common assessments of financial policies.

At the same time, there remain serious and unresolved questions about the governance and scope of these institutions. Addressing these issues is essential to reaching global consensus on key short-term issues, such as a coordinated fiscal stimulus package. The experts assembled in Washington, DC and London devoted considerable time to evaluating the strengths and weaknesses of these organizations and developed a set of recommendations designed to increase the role and resources of the IMF to conduct surveillance and monitoring of global fiscal stimulus packages and support increased liquidity; balance voting weight and representation within the IMF governance structure to ensure that they effectively and accurately represent emerging and developed economies; and increase the scope and membership of the FSF to improve its ability to serve as a cross-sectoral forum for discussion on financial regulatory issues.

Participants agreed that given the impact of the crisis on emerging economies, the G20 should announce full support and reaffirmation of the IMF and FSF as the pre-eminent multilateral financial and monetary institutions with the capacity and experience to assist member governments to address the current economic challenges. The G20 should concurrently announce a substantial increase in IMF resources, with a doubling or even tripling of current financing to assist countries in immediate crisis. The IMF and multilateral development banks should also announce an immediate commitment to increase public financing through the international capital markets. Brian Henderson suggests that the regional multilateral development institutions could receive extra funding from the sovereign wealth funds of some of their most prosperous members.

Domenico Lombardi, Susan Schadler and Andrew Baker present different strengths of the IMF, FSF and WTO to tackle the immediate challenge of resurrecting global demand and guarding against protectionism. All participants agreed that the G20 must provide a strong mandate to the IMF, the FSF and the WTO to work together to evaluate scenarios of immediate and long-term effects of varying and competing stimulus packages. The capacity to effect both crisis alleviation through liquidity support and policies against protectionism is fully within the competence of these institutions. Raghuram Rajan recommends that the multilateral institutions should encourage dialogue on policy coordination, particularly in the case of crises, but also ensure that policies implemented do not result in unfair competitive advantage.

Over the longer term, our experts broadly agree that the G20 should commit to reforms of the governance and voting structure to reflect 21st-century economic reality. Ralph Bryant stresses that G20 leaders should reopen negotiations on IMF reform. This would help to increase the credibility of the institution as well as encourage greater financial participation in capitalizing the IMF. He goes on to argue for greater transparency and inclusiveness in the selection of IMF leadership. Rajan recommends that the size of the IMF Executive Board be reduced and that regional representation be balanced in order to increase its effectiveness. This should include a reduction in the number of European representatives, as both Lauren Phillips and Andrew Baker have outlined, and the allocation of seats to representatives from within the G20, including the Middle East, Asia, Latin America and Africa. Many of the panellists agree on the need for European consolidation, not just at the IMF, but in general at the institutions governing the global economy.

The G20 meetings should also increase the IMF's mandate for macro-prudential surveillance. According to Susan Schadler, the IMF, with its deep expertise and large secretariat, is well positioned to carry out this function, but will require a greater mandate to do so. Andrew Baker outlines how the IMF and FSF should work together to ensure that their relative areas of expertise reinforce each other.

The combined force of these recommendations will revitalize the core of the Bretton Woods organizations. It has been clear to many for some years that such adjustments are critical to ensure that these institutions, which were designed to ensure global financial stability, become more relevant and effective. Making bold reforms now will rebuild badly needed confidence and trust in the integrity of the international financial system.

The World Economic and Financial Crisis: Next Steps for G20 Cooperation

Ralph C. Bryant[1]

The worst of the contraction in world output and employment is yet to come. Financial turmoil may well continue. Government cooperation to mitigate the effects of the crisis and to avoid beggar-thy-neighbour policies is badly needed. The meeting of G20 heads of state in London on 2 April is a crucial opportunity for leaders to agree on actions that will combat the crisis.

Failing to cooperate could weaken confidence further and worsen the crisis. The disaster of the 1933 London World Economic Conference, occurring at a similar time of worldwide economic distress, is a reminder of the damaging effects that can occur if leaders fail to act cooperatively.

The needed cooperation is of two sorts. With fires already raging, the existing fire brigades must fight the short-run acute problems. But because the existing fire stations, their equipment and fire regulatory safety codes (i.e. our financial infrastructure) are inadequate, efforts to rebuild are required to assure that fires can be better fought over the medium and long run. One's first thought may be to concentrate solely on the acute problems, postponing rebuilding agreements for later. Agreements on how to fight the acute fires of today, however, will not be reached without credible commitments to rebuild the fire stations and regulatory codes for tomorrow. As G20 leaders plan their 2 April meeting, they should focus on agreed actions to address the immediate emergency but also on specific commitments to enhance intergovernmental cooperation over the longer run.

If far-sighted, the G20 leaders will strengthen the powers and stature of international institutions as conduits for their cooperation. For now, the most critical needs are at the International Monetary Fund, the Financial Stability Forum and groups charged with responsibilities for supervision and regulation of financial institutions (such as the Basel Committee on Bank Supervision). Such strengthening is very much in the interests of all countries – large and small, rich and poor. Yet few governments are strongly committed. The United States has not acted as though an effective IMF is essential for supporting its goals and prosperity. The Europeans have been preoccupied with maintaining their disproportionately large share of IMF voting rights and Executive Board seats, rather than promoting a stronger, more effective institution. Emerging-market nations such as China, India, Brazil and Mexico likewise do not perceive the IMF as an institution serving their fundamental interests. Yet those national views are all short-sighted. They underemphasize, if not ignore completely, the fact that appropriate strengthening of the international institutions can advance the collective interests of all nations.

International institutions have not always functioned effectively. They have not been given sufficient authority to conduct multilateral surveillance, and have been timid in exercising the limited powers they do have. Their analytical capacities are not strong enough. For today's world, their governance has major flaws. Despite their weaknesses, however, they can and do play a positive role. In the current crisis, the world community has no better choice than to rely on these institutions and needs to strengthen them as quickly as possible.

A collective bargain among all nations is required to support near-term actions and to reform the institutions for the longer run. It is true that some needed reforms are a zero-sum game. For example, the share of voting rights of many developed countries, particularly in Europe, must fall so that the share of under-represented countries such as China, India and Brazil can rise. But many other aspects of needed reforms are a positive-sum game. Most notably, major developed countries and large emerging-market countries could join together to negotiate a strengthening of the IMF, the Financial

1. This is a slightly modified version of the author's paper published by Brookings on 11 March 2009, at http://www.brookings.edu/opinions/2009/0311_g20_bryant.aspx.

Stability Forum and other institutions that would prove mutually beneficial to all countries in the world.

The specific short-term commitments detailed below could be an initial instalment of that collective bargain. Judged from the perspective of the London summit meeting, each component is a short-term 'deliverable' for the summit communiqué on 2 April.

The G20 leaders should:

(1) ***agree on a cooperative package of macroeconomic policies, highlighting especially fiscal stimulus programmes***. The package should contain a fiscal stimulus programme for each country that has policy space to implement fiscal expansion. The programmes should contain specifics for each country. Equally important, the IMF should be charged with monitoring the implementation of the specific programmes and prominently identifying countries that are not adequately pulling their weight. The leaders should pledge that they want the IMF monitoring to have 'teeth'. A credible commitment to support IMF monitoring is a promising step that leaders can take to bolster confidence that cooperative policies will mitigate short-run contractions in output and employment. The commitment would also be a down payment on strengthening the IMF's multilateral surveillance of countries' macroeconomic and exchange-rate policies over the longer run.

(2) ***negotiate a counterpart agreement for monitoring the commitments of countries to avoid beggar-thy-neighbour policies***. The WTO and perhaps also the IMF should be given an explicit mandate to report regularly on the entire range of countries' policies affecting cross-border transactions. Countries that sail too close to the wind with policies that have protectionist effects, either for goods-and-services trade or for financial transactions, should be named and shamed. G20 leaders must credibly indicate that they support this monitoring and will not undermine the international reports even if their own countries are criticized.

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(3) ***urgently plan to provide additional resources for IMF lending and to ask for revisions in its terms and conditions***. Substantially larger resources are needed in the short-run emergency, and for the medium term as well. Access and conditionality provisions for IMF lending facilities will require changes. The needs are especially acute for low-income countries and for some emerging-market countries experiencing a severe shortfall in net capital inflows.

The preferred method by far for increasing the IMF's resources is to expand aggregate quotas. An expansion of the New Arrangements to Borrow (NAB) is also warranted. But those desirable changes cannot be adopted quickly because they must be preceded by time-consuming negotiations and be accompanied by a major reform in the governance of the IMF (point 4 below).

For the immediate future, therefore, the G20 leaders have only two practical choices. One is to ask for approval under existing IMF procedures for (3a) ***a large one-time immediate SDR allocation*** – at least the equivalent of $200 billion. As an interim step, a large SDR allocation could be implemented promptly without any change in the IMF articles (it would require an 85 per cent voting majority). An SDR allocation is an imperfect, blunt instrument for an immediate expansion in world liquidity. The largest fraction of an allocation, some two-thirds, would go to countries for which the direct benefits would be small or non-existent. Nevertheless, the effects for the world as a whole would be unambiguously positive. Because the world financial and economic system faces a severe emergency, the effects of an SDR allocation could help substantively and as a way of boosting short-run confidence.

The other short-run choice for increasing IMF lending resources is (3b) ***augmented bilateral borrowing from particular IMF members***. The recent special borrowing of $100 billion from Japan is an initial example that the IMF Managing Director hopes to supplement with analogous borrowings from other high-reserve countries. This approach can help provide immediate resources. But ad hoc borrowings from individual countries are at most an interim step. A major difficulty is that several of the other candidate countries for bilateral borrowings – China being the most prominent – may justifiably prove reluctant to lend in the absence of a greater voice and representation in the IMF to better reflect their weights in the world economy.

(4) ***pledge to reopen international negotiations about the financial resources available to the IMF and about the entire range of IMF governance reforms, because of the inevitably close links between the two***. A commitment to negotiate comprehensive reforms is primarily a matter of rebuilding the IMF fire station rather than fighting this year's fires. But that commitment is essential to encourage the necessary cooperation for this year's firefighting (in particular the active participation of China and other large emerging-market nations). Although a reform package was agreed by the IMF membership in April 2008 after three years of negotiations, those reforms were timid and inadequate. Further government and legislative consideration of that package should be deferred. Instead, G20 leaders should commit the IMF and their finance ministers, deputies and staffs to renewed negotiations over the coming year. The leaders should set an explicit timetable and ask for definite progress by the annual meetings of the IMF and World Bank in autumn 2009.

The bold package to be negotiated should:

- provide a major increase in the size of aggregate quotas (at least a doubling);
- review and expand the arrangements for borrowing under the NAB;
- refine the terms for member borrowing from the IMF's Short-term Liquidity Facility;
- revise the terms for members' access to other IMF facilities;
- incorporate an improved formula to serve as a basis for determining quota and voting-rights shares;
- revise the composition of the Executive Board and of member constituencies, reducing the number of Executive Directors to no more than 20;
- eliminate the provision that prohibits split voting within constituencies;
- reduce from 85 per cent to 80 per cent the required special-majority vote for many key decisions;
- retain the tripling of basic votes agreed in the April 2008 package;
- enhance the mandate for IMF multilateral surveillance and macroeconomic oversight of the world economy, including exchange rates;
- strengthen the analytical capacities of the IMF staff for conducting such surveillance.

(5) ***announce an agreement that leadership selection at the IMF and World Bank will henceforth be solely based on merit, with candidates considered from any nationality***. This would be a credible down payment on the comprehensive IMF reform to be negotiated in the coming year and as a step to bolster short-run confidence. Leadership selection should require a double-majority voting approval (analogous to that required for approval of amendments to the IMF and World Bank Articles of Agreement). This agreement would render obsolete the long-standing but now inappropriate convention that European governments designate a European to be Managing Director of the IMF and the US government designates an American to be President of the World Bank. (A joint US and EU statement reiterating the agreement could be timed to coincide with the G20 communiqué.)

(6) ***reiterate commitment to reforms of the international institutions with responsibilities for catalysing cooperation about prudential oversight (supervision and regulation) of financial institutions***. Insufficient time exists before the 2 April meeting to negotiate sound, specific measures in this area. Most such measures in any case pertain to the longer-run task of rebuilding the fire station and designing better fire safety codes. An immediate step can be taken to broaden the country participation in the Financial Stability Forum and restructure the arrangement of the seats around the table. Expansion should likewise occur in the countries participating in the Basel Committee on Banking Supervision, the International Accounting Standards Board, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors. The primary responsibility for improved financial standards and prudential oversight, it is true, necessarily resides within individual nations. But the G20 leaders should build on their November 2008 agreement by credibly committing their countries to intensified cooperation to develop agreed world minimum standards and to provide monitoring and enforcement of those standards.

Some Principles for a New International Architecture

Raghuram G. Rajan

The objectives of a new global economic architecture are to (i) reduce the barriers to trade, and as a country's capacity to handle them increases, capital flows; (ii) ensure that a country's policies or regulations do not, through the route of trade or capital flows, give them an unfair competitive advantage or destabilize other countries; and (iii) have a system to discuss policies and coordinate some of them in case of crisis, as well as supply pooled funds to countries that are willing to make the necessary adjustments.

The current crisis has highlighted a number of important deficiencies in this system, perhaps reflecting the fact that many of its structures were set up in a different era. The ongoing global crisis is as much a consequence of macroeconomic imbalances, resulting in both large sustained trade deficits and surpluses, as it is of poor governance in financial markets and inadequate regulation. We need an effective, high-level, inclusive and even-handed mechanism through which unstable situations are identified, a dialogue is initiated with relevant countries, and countries are persuaded to alter the policies that lead to imbalances. The current system is neither sufficiently high-level when it is inclusive, nor perceived as even-handed enough, to be effective.

In addition, when a crisis hits, the system for coordinating responses across countries and across multilateral organizations is ad hoc and incomplete. Finally, while the existing system provides funds to countries under International Monetary Fund programmes of varying rigour, in order to deter countries with responsible policies from building excessive individual reserve hoards, we need to create a system of pooling reserves where funds will be available to such countries on demand.

If the ongoing discussion on global architecture is to make a difference, it should address these important issues. The problems with the current system and possible avenues for exploration are briefly outlined below.

Architecture

The Executive Board of the IMF is representative of countries around the world but is probably too large and staffed at too low a level to take important decisions; this deficiency in turn spawns parallel bodies such as the G20, which slows decision-making. Two changes could transform this board into a world Economic Committee that is effective, high-level and inclusive. First, its size could be shrunk, in particular by reducing the number of representatives from Europe. Second, the permanent board could be disbanded (which would also free up resources that are engaged in making routine reports) and replaced by a regular quarterly meeting at the ministerial level (with meetings at the deputy-ministerial level for more routine tasks, and meetings twice a year at the head-of-state level). Instead of discussing every country's Article IV, or every application to borrow, the Economic Committee would focus on issues of policy spillovers that have collective macroeconomic impact, and involve large allocations of Fund resources.[1]

The IMF would both be governed by the Economic Committee and serve as its secretariat. Its own functioning would be key to making the Economic Committee appear even-handed. Among the necessary reforms are:

- making the selection of IMF management transparent, not contingent on nationality, and broadly representative of the membership;
- making the Fund self-financing so that it does not have to keep going back to key shareholders;

1. Fund management would review Article IV reports and routine progress of IMF programmes, and only flag issues of systemic concern for the Economic Committee.

- eliminating any country's official veto power over major decisions;
- allowing the Fund's agenda to be set by the Economic Committee rather than outside bodies.

The important development role of the Economic Committee would be to identify and reduce structural impediments to cross-border investment, consistent with countries' ability to absorb flows. Its role in ensuring stability would be to identify and remedy situations where large countries run sustained large deficits or surpluses that can make the system more fragile, cause the volume of damaging political rhetoric to increase, and impose the burden of adjustment on others. It should also play a role through the Financial Stability Forum and the IMF in monitoring financial sector regulation and coordination among regulators. Finally, in times of global stress, crisis management (including the disbursement of resources) would be coordinated by the deputies, who would have built relationships with one another in normal times.

Facilities

In addition to existing facilities, in the event of inevitable policy mistakes, we need a process by which global reserves are pooled and responsible countries given credible commitments that they will have easy access to funds when in need. Indeed, the expectation of access can reduce the need for a country to run the large, sustained trade surpluses that have contributed to global imbalances. Given the opprobrium attached to borrowing from the IMF, it is worth considering whether a separate facility, advised by the Fund but governed by members (possibly a subset of Fund membership who contribute their own money to the pool), is needed.

Penalties

What if a country, following policies that are not in the collective interest, refuses to be persuaded? Before any discussion of penalties, it is important that the above reforms to make the system even-handed are undertaken so that assessments identifying problem countries can be seen as unbiased. Even so, macroeconomics is not an exact science, so any attempt to prove beyond reasonable doubt that a country's policies violate international norms is fraught with difficulty. For instance, countries with different levels of income and different demographic profiles would naturally have different levels of imbalances, though the correspondence is not exact. Judicial processes along the lines of those followed by the World Trade Organization are unlikely to be effective.

One option might be to continue relying on peer pressure and the threat of bilateral political action. This has not worked so far, though international dialogue has rarely progressed to the point where sustained peer pressure can be exerted. Alternatively, transparent rules might be devised – for instance on the maximum size of the imbalance a large country at a certain level of development and with a certain demographic profile is allowed to run for a sustained period – along the lines of the deficit rules in the Eurozone. Countries would be given time to get their imbalances in order, and if problems persisted after this period an increasing scale of trade or monetary penalties would kick in.

Developmental issues

A number of developmental issues, such as global food security, resource sufficiency and global warming, are best tackled by the World Bank and have therefore not been addressed here. While the governance of the World Bank needs to change in tandem with that of the IMF, there might be less need to replace the Executive Board, since the pace of policy development there can be more measured. Nevertheless, it is worth asking whether routine oversight by a permanent board is needed on so many matters.

Final concerns

This crisis offers an opportunity to undertake serious reform of the global architecture to make it more effective and fair. If we emerge from the crisis with the existing architecture intact, and only a few additional steps to coordinate financial regulation, we will have missed that opportunity. It is to be hoped that crises like the current one are few and far between. We should take full advantage of it.

Enhancing International Institutions

Brian Henderson

The global financial crisis has exposed or revived the great need for the international institutions created to provide for the proper functioning of the global economy and to assist countries facing acute balance-of-payments difficulties. The IMF in particular has been extremely active recently in coordinating financing in many of the emerging countries and small economies hit hardest by the global economic downturn. Its role as global 'fire-fighter' has been reinvigorated. The Bretton Woods institutions will be of great importance as we work to revive the global economy. The G20 countries must empower these institutions further to more effectively play their role in global economic revival. The G20 can take steps to encourage the multilateral financial institutions to accelerate their access to the market; reach consensus on increasing special drawing rights (SDR) for qualified member countries and/or those in need of support; let the regional multilateral development institutions (MDIs) encourage their member states to motivate their more prosperous members to allocate a portion of their sovereign wealth funds (SWFs) towards assisting in funding the regional MDIs, and use the IMF and World Bank as the 'clearing institutions' for benchmarking the economic and monetary performance of all member countries.

The multilateral financial institutions which constitute the institutional result of the Bretton Woods agreements of over sixty years ago remain in solid financial condition and are viewed by the international capital markets as high-quality financial risk, meriting continuing credibility and 'AAA' ratings. In most markets the 'Group' are able to command 'best pricing' for their bonds and are viewed as the better credits in the sovereign/government asset class. The level of issuance is still significant for the markets, providing credible alternatives for investors across the entire spectrum of the yield curve. Many institutions, including pension funds, government agencies, financial institutions, insurance companies, foundations and individual investors, view the risk of these agencies as safe and of the highest stability and return on investment. Indeed, in today's market, these are viewed as 'safety nets' or proxies for benchmarking other financial risks in the sector or in managing liquidity across all asset classes.

By the end of February 2009, all the AAA-rated multilateral institutions combined have been able to access public markets with an excess of $33 billion in issuance, compared with a total for 2008 of $136 billion. The single largest issuer has been the European Investment Bank, representing in the first two months of 2009 as much as 77% of the total for 2008 and 88% of issues for the asset class. While the market exists and is receptive, even these institutions have had to 'pay up' on spreads, as the global credit crisis has put a premium on any sort of placement, given the sclerotic condition of the market. In this context, these immediate short-term recommendations are offered.

First, the multilateral financial institutions should be encouraged to accelerate their access to the market as a means to provide liquidity, to pre-finance initiatives on as long-term financing terms as the market will bear, and to announce such an initiative publicly. The IMF would signal this as a challenge to the associated regional institutions to join in the initiative to accelerate regional support for continuing development and structural and emergency aid to member states and/or infrastructure projects. As a collateral benefit of the announcement, the private-sector financial institutions would have the incentive to compete for the underwriting business, and to continue to intermediate the liquidity of such accelerated issuance volumes and sustain the market for this asset class.

Second, a consensus must be reached immediately on increasing SDR for qualified member countries and/or those in need of support. This would reduce the foreign exchange burden on those countries that can least afford this additional risk in the current environment.

As the challenge for both credit and capital will remain in the markets for at least the next 18 months, the regional MDIs should, in turn, encourage their member states to motivate their more prosperous members to allocate a portion of their SWFs towards assisting in funding the regional MDIs. Specifically, the African Development Bank, Asian Development Bank and Inter-American Development Bank should be able to receive from those member states with sizeable SWFs an allocation of funding, either through the capital structure directly or through specifically defined facilities, which would be allocated to structural adjustment and/or regional projects of benefit to both the 'donor' state as well the region as a whole. There are a number of infrastructure projects, including ports, airports, roads, railways and environmental projects across the globe, which could benefit from such an accelerated commitment of resources. The benefits of the broader world economy would also be significant in terms of trade and services. The European Bank for Reconstruction and Development should immediately announce an increase in capital resources and commitments from the EU to further assist central and east European states in addressing the economic dislocation of the current economic challenges for the region, as well as providing more conventional longer-term development financing for accelerated regional infrastructure projects.

Lastly, the IMF and World Bank should be used as the 'clearing institutions' to benchmark the economic and monetary performance of all the member countries, and specifically to accelerate the availability of dedicated teams of experts who would provide immediate assistance to those countries in most need of expert counsel. A majority of underdeveloped countries do not have the human resources available to focus properly on immediate priorities and develop rational plans for managing the current global crisis. The wealthier countries should channel their foreign assistance programmes, especially their professional and technical expertise, through coordinated efforts with both the IMF and the World Bank.

After the Fall: Reasserting the IMF in the Face of Global Crisis

Domenico Lombardi

Under the pressure of the current crisis, the international community is carving out a new role for the International Monetary Fund. But this is not the first time. Every decade or so, the institution has slightly changed its role in the global system. In the 1970s it relinquished supervision of the Bretton Woods exchange rate system and lost its role as forum for global economic coordination. Ten years later it assumed the role of manager of the emerging debt crisis. When international financial risks related to the debt crisis waned, the IMF targeted the task of 'systemic transformation' in Russia and its former satellite states. That function, too, became obsolete, and the Fund reasserted itself in the face of the Mexican, East Asian and other financial crises of the 1990s by engaging in large-scale emergency lending. Once that was no longer needed, the institution underwent a period of inactivity, leading many to wonder if there were any role at all left for the IMF in the international monetary system.

Now, once again, policy-makers are looking to the IMF to define a new, more meaningful role for itself. What exactly that should be is currently the subject of discussion in various groups such as the G7 and, especially, the G20. It is also what the Manuel Commission is working on (the report of this group of experts chaired by the South African Finance Minister Trevor Manuel is expected to be made available by April 2009).

In what follows, I shall draw some lessons from the current economic crisis, deduce the implications for IMF reform and, finally, share some concrete proposals.

Lessons from the current crisis

This financial crisis can be attributed to the past seven years of low interest rates and high world growth. While macroeconomic forces were at work in the guise of low interest rates driving investors to seek out higher returns, the financial system, partly in response to this, came up with new structures and financial instruments offering higher risk-adjusted returns, instruments in fact far riskier than they seemed. It was not long before market discipline fell short, as optimism prevailed and due diligence was outsourced to credit rating agencies.

In this setting, there has been fragmented surveillance with policy debates scattered across various fora such the Bank for International Settlements, the G7 and G20, the Financial Stability Forum, and, of course, the IMF. And there has been insufficient cooperation among national financial regulators, as well as lack of engagement of world economic decision-makers in time to make a difference.

Implications for IMF reform

Not even amidst the red flags and distress signals was any real system of collaborative global action set in motion. For instance, the disorderly unwinding of global imbalances had long been recognized as a major systemic risk. Yet collective action in that regard proved less than satisfactory: the IMF's Multilateral Consultation of 2006–07 produced only the slightest interest on the part of its participants. Once the crisis was in full swing, the policy response remained neither very collaborative nor very coordinated.

To be fair, this has been pretty much in line with the traditional response of the international community to the episodes of instability affecting the world's monetary and financial system since the 1980s, and for which the response has been conducted on a case-by-case basis, with an emphasis on domestic factors rather than on systemic determinants.

This just happens to reflect the underlying contradiction in the vision of the IMF that the international community has held since the 1970s, following the end of the Bretton Woods era. On the one hand, powerful members of the Fund have been pushing for it to have a stronger surveillance role; on the other hand, these same members have not delegated to the institution enough powers to do so in ways that might be more effective. They have provided it with neither adequate authority nor effective instruments of enforcement. They have been reluctant to endow the IMF with political capital, making it ineffective as a forum for multilateral solution-finding.

For instance, in the latest round of IMF reform in the aftermath of the Asian crisis, it was asked by key shareholders to devise the Financial Sector Assessment Programme (FSAP) with the aim of stepping up its financial sector surveillance. Yet to date neither the US nor China has undergone such an assessment. That same round of reform sought to close the loopholes in the financial regulatory regime, prompting the IMF to focus on offshore financial activity on small islands, rather than on the toxic assets and financial vulnerabilities being accumulated in systemically relevant economies.

Though the need for cooperation is now finally recognized, there is no central body to assume leadership for responses to systemic risks in the global economy, while the debate has shifted to smaller and more flexible groups. The IMF has not been effective in this debate so far, partly owing to the lack of a truly representative and effective Executive Board and International Monetary and Financial Committee (IMFC).

Reforming the IMF

Against this background, the G20 leaders' meeting in Washington in November 2008 set off a process that could lead to a fundamental reform of the world's monetary and financial system. It is not clear yet how much they will be able to achieve.

But whatever they come up with has to be assessed against the yardstick of whether or not their decisions provide the international monetary system with a credible institutional anchor, i.e. whether or not the IMF will come out of these discussions with an enhanced mandate from its shareholders.

With that principle in mind, the following proposals have benefited from discussion with my colleagues of the Bretton Woods Committee. The thrust of these recommendations is first to make the decision-making system of the IMF, but also of the World Bank, far more transparent and inclusive. An obvious way to institutionalize this requirement is to introduce the double majority requirement for major decisions. (This would also, incidentally, end Euro-American dominance of the Bretton Woods institutions, since smaller and poorer countries would have a stronger say in the leadership selection process.)

Inclusiveness and a greater sense of ownership of the Bretton Woods institutions also require a more balanced distribution of voting power between developed and developing economies. In this regard, it is important that the IMF continue to simplify its quota formula, making it more responsive to the changing economic realities of the 21st century.

The ensuing reallocation of voting power will spur a change in the composition of the Executive Boards – that is, the policy-making organs of the IMF and the World Bank, with developing countries enjoying a broader representation than is currently the case. That said, such changes in quotas and representation are not mechanically correlated. A more representative and effective board requires one key reform: that European countries consolidate their representation. This could be accomplished in a number of ways – for instance, having one chair representing Eurozone countries and another chair representing all the other EU members.

The representation of the Eurozone chair(s) could be entrusted to the European Central Bank and the EU Commission, or be a multi-country constituency where the concerned member states would agree on their internal representation. Whatever the variant chosen, the two basic premises are that: (i) the Europeans must bring consistency in their representation on external monetary affairs, as they have done, for instance, with trade policy; and (ii) France, Germany, and the UK should commit, either for Europe or for the world at large, to relinquish the 'exorbitant privilege' of holding single-country appointing chairs.

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Seizing the Moment at the London Summit

Susan Schadler

Comparisons of the London Summit of 2009 with the failed summit of 1933 abound. Picture this failure scenario for 2009: driven by the highly commendable objective of reforming the International Monetary Fund (or indeed the overall institutional architecture), G20 leaders succumb to political manoeuvring that blindsides the summit to the four priorities for immediate action: agreeing on approaches to sharing the burden of demand creation, preventing demand diversion (i.e. protectionism), repairing banks' balance sheets and financing crisis support. In short, the risk for the 2009 summit is that it gets lost in global governance reform, a goal which, even if pursued successfully, will not pull the global economy back from the precipice.

As far as the IMF is concerned, G20 leaders should focus on how to deploy immediately the institution's three great and distinctive strengths: a sizeable (and in principle apolitical) secretariat with deep expertise in advising on macroeconomic policies to alleviate crises; a pot (albeit limited) of financial resources to support countries in crisis; and an established surveillance mechanism, which through direct contact with every country every year can deliver information on and assessments of macroeconomic policies.

Surveillance – assessing the burden of demand creation, monitoring demand diversion

Alongside repairing banks' balance sheets, coordinated demand stimulus is the most pressing requirement for getting the global economy back on track. The process has started, but at this juncture there are major risks of popular backlashes based on perceptions that one or a few countries are doing too much of the heavy lifting – taking on too much of the future tax burden of stimulus. A slow or weak recovery will compound these risks. At the same time, it will be a small step from these concerns to public pressure for all manner of tactics to divert demand in the countries with the biggest stimulus programmes to their domestic markets.

To resurrect global demand and prevent protectionism, a central arbiter and watchdog is essential. The IMF is the only international institution with the capacity right now to perform both these roles. The G20 needs to provide a strong mandate to IMF staff to work through scenarios of medium- and long-term effects of various distributions of demand stimulus. These will be the foundation for discussion and agreement within the G20 at the earliest date possible (ideally no later than June 2009) on the burden-sharing of demand stimulus. After an agreement has been reached, IMF staff surveillance should report quarterly to the G20 on its implementation. This responsibility would sit squarely within existing staff competences.

The second contribution IMF surveillance can make is monitoring demand diversion. This time around, protectionism is unlikely to occur predominantly through flat-footed measures such as raising import tariffs. More likely are measures that subtly redirect demand, for example through changes in tax codes, product standards, financing mechanism or government procurement practices. Should this not be an issue for the World Trade Organization? Ideally, yes, but not in its present state. The WTO's very small secretariat has infrequent reviews of individual countries' trade policies and a constrained mandate for assessing those policies. IMF surveillance – entailing annual visits to every country in the world – is the only option readily available. That said, the IMF's disengagement on trade policy issues during the past decade means that it has little. if any, expertise on trade policy issues. It will therefore need substantial support from the WTO, as well as the World Bank and OECD. But for the important and urgent monitoring task at hand, there is little choice but to use the existing infrastructure of IMF surveillance.

Rescuing countries in crisis – principles and financing

Lending programmes are being put together in global conditions without historical precedent in the IMF's experience. Also, they are being constructed in the shadow of a severe backlash against the intrusion of IMF conditionality into structural policies, particularly during the Asia lending operations in the late 1990s. These two facts mean that the IMF stands to get things wrong unless members agree on basic principles quickly.

The IMF's approach to conditions on its loans in crises is essentially designed for 'atomistic' cases – where one country, through bad policies and/or bad luck, cannot meet its external payments obligations without a crippling compression of demand, but where the rest of the world economy is still growing. On occasion, crises have hit regions; but even then growth in other regions has been normal. The IMF's conventional prescription is a blend of adjustment and financing: cut domestic demand, strengthen competitiveness so that the country can export its way out of the crisis, and use IMF financing to buy some time, smoothing the imposition of austerity measures and thus softening their impact. All of this is fine if markets for the country's exports are growing. If not, unpleasant surprises about how much demand contraction is needed to stabilize debt will be in the offing. And while the countries that have come to the Fund have so far been those whose crises were precipitated by particularly bad fiscal and financial sector policies (where contractions are unavoidable), the next batch will come from higher up the food chain. Should countries that had sustainable policies and may even be large in the global economy follow the route of demand contraction?

Two aspects of the approach need changing. First, the IMF's retreat from conditions on structural changes for economies in crisis needs to be reversed. Less reliance on immediate demand contraction is possible only with more financing or confidence-boosting reforms that will position crisis countries to weather a potentially lengthy period of weak global growth and limited external financing. The IMF (helped by the World Bank and OECD) needs to re-engage in structural issues. Countries with looming pension or health-care imbalances, barriers to productivity growth and competitiveness, and poor environments for doing business need to come up with concrete commitments to change. The IMF is not equipped to do this on its own. Rather, crisis teams including the World Bank and OECD will need to work off the example of collaboration on Financial Sector Assessment Programmes to construct structural recovery programmes.

Second, realism on financing requirements is needed. So far, the IMF's over-optimistic forecasts for the global economy mean that financial backing of crisis countries' programmes is likely to be insufficient. There needs to be at least a doubling of the IMF's financial resources. This will not happen through quota increases within the relevant timeframe. Diverse funding procedures are essential and urgent. Ideally, countries with large reserves and/or strong fiscal positions would come to the G20 meeting ready to put money on the table, following the Japanese example, and commit to other innovations. For example, the Federal Reserve and other central banks already have swap lines with some emerging markets, and the Chiang Mai Initiative[1] makes swap lines available to Asian countries. Financing of programmes backed by the IMF could certainly be bolstered by co-financing through these swap lines (with arrangements for automatic rollovers and repayment at the same rate as for IMF resources).

Reform of IMF governance – set work towards the goal in motion

Improving the outmoded and haphazard IMF governance is critical to its viability. Its Independent Evaluation Office recently completed an evaluation of governance that points to the need to reallocate voice and quota, raise the level of representation of members in the Fund and strengthen oversight of management. A critical addition to

1. The Chiang Mai Initiative refers to the agreement between the ten members of the Association of South-East Asian Nations (ASEAN) plus Japan, China and South Korea to make bilateral currency swap arrangements available to each other. This regional emergency reserve fund is currently worth $120 billion.

this list should be to rethink the roles of rules and discretion in guiding international monetary cooperation. These are necessary changes for the organization to regain its footing, but they will take time. Committing to an agenda for accomplishing this change should be the governance goal for the London summit.

The IMF can be immensely useful as a tool for helping the world through the crisis. True, it would be even more useful with better governance. But the G20 can use the IMF – even with its flaws – if it takes charge of the deployment of the Fund's attributes. Two caveats are needed, however. First, time is of the essence. The IMF needs immediate guidance and oversight from the G20. Second, the Fund should not be overloaded. Contrary to perception, it is not an institution adept at multitasking, particularly outside its expertise in macroeconomic policy, and its infrastructure must be immediately guided to the urgent tasks at hand.

The UK, the G20 and IMF Reform

Lauren M. Phillips

This contribution argues that now is the moment to collapse European representation in the International Monetary Fund into a smaller number of constituencies, and that the United Kingdom should lead on this issue by volunteering to give up its seat – not because it is the 'right thing to do' from a fairness or development standpoint, but because it can derive specific political and material advantages from doing so.

As I have written elsewhere,[1] reorganizing (or 'rationalizing') the votes of European Union member states has been central to most proposals for IMF reform. Authors with a more sympathetic view of the EU and its member states have focused on how this change would enhance European power in the Fund, while others have focused on how this would help achieve greater legitimacy for the IMF and give a greater voice to developing countries.

Despite the centrality of this idea in the literature on IMF reform, the topic was 'off the table' in recent negotiations on quota reform that culminated in the package announced in April 2008. Nonetheless, pressure for greater European coordination has increased rather than decreased. Policy-makers in the US and China, and even within the EU, continue to stress the importance of changing EU representation in the IMF.

For example, the US Treasury Under Secretary for International Affairs, David McCormick, advocated a reduction in the number of seats on the IMF Executive Board, by having fewer European seats.[2] The Chinese Premier, Wen Jiabao, commented that the IMF 'should increase the voting share, the representation, and the say of developing countries' before China will consider making additional contributions to the Fund.[3] Alan Beattie of the *Financial Times* interpreted the statement to mean that 'Europeans may have to make prior commitments to a shift in voting power – at the very least accelerating the next discussion of IMF quotas from its planned date of 2013 to 2010 or 2011 – if they want to attract contributions [from China and other emerging-market countries]'.[4] Finally, European policy-makers themselves have acknowledged that 'achieving a single euro area chair in international fora has so far been considered an objective for the longer term. But the world is moving faster and we need to reconsider our timetable.'[5]

Given this broad-ranging support, the idea of rationalizing European representation seems to be an inevitable next step in IMF reform. It is better for the UK to lead the charge on this topic than follow a reform agenda set by other European states, by the US or by large developing countries.

There are five advantages in using the UK's current leadership of the G20 to focus on a change to EU representation in the IMF.

First and most importantly, unilateral action by the UK during the 2009 G20 summit on this critical issue of Bretton Woods reform will allow it to set the scope of the reform, and to frame the issue in the most favourable light to achieve its interests. Being the agenda-setter is an advantageous position in international negotiations.

Second, the UK will accrue a massive amount of goodwill from developing countries, development-oriented civil society and the United States, which is keen to see a change in European representation. The UK will enhance its credentials as a pro-development, pro-reform member of

1. Phillips, L., 'Lead, Follow or Get Out of the Way: The Role of the EU in Reform of the Bretton Woods Institutions', XXVI G24 Technical Meeting, Geneva, 16–17 March 2006.
2. David H. McCormick, US Treasury Secretary for International Affairs, 'IMF Reform: Meeting the Challenges of Today's Global Economy', Washington DC, 25 February 2008.
3. http://www.ft.com/cms/s/0/795d2bca-f0fe-11dd-8790-0000779fd2ac.html.
4. Beattie, A., 'A gap to fill', *Financial Times*, 2 March 2009.
5. Joaquín Almunia, European Commissioner for Economic and Monetary Policy, 'Reinforcing EMU after the first decade', Brussels, 17 January 2008, Speech on the occasion of the 20th anniversary of the Representative Office of the Österreichische Nationalbank.

the international community, consistent with its behaviour on topics such as multilateral debt relief, the voice of low-income countries in global governance, the Millennium Development Goals and broader issues of aid allocation.

Third, a shift in the UK position opens up many possible permutations for European representation in the IMF. As the positions of smaller EU countries have often been framed *vis-à-vis* the positions of the UK and other single-member constituencies, this unexpected move would provide a large degree of flexibility.

Fourth, from a material standpoint, moving towards more rationalized European representation in the Fund will create possibilities for greater financial contributions from China and other countries with high foreign reserve levels. Given the probability of upcoming financial distress in Europe and on Europe's fringes, the UK would do well to find alternative financing for IMF support in order to minimize the ad hoc contributions it will be asked to make.

Fifth and finally, by framing the context of negotiations, the UK can ensure that the restructuring of European constituencies does not require changes in the formal delegation of competencies to the European level. Although EU policy-makers have argued that the underlying European architecture on financial and monetary issues must be changed before representation in the IMF is addressed, there is no legal reason why this is the case. The UK could advocate a change in its own and other countries' representation without delegating further monetary or financial authority to Brussels.

The domestic political costs of moving on this issue appear to be relatively minor. While the Conservative Party opposition in the UK might attempt to characterize this move as delegation of authority to Europe, it would be hard to do so for at least two reasons. First, representation in the IMF is a highly technical issue, about which the average voter understands little and probably cares less. It would be difficult to achieve great traction on this issue as a serious point of domestic political contestation. Second, by leading on this issue, the UK can ensure that the negotiation does not ultimately lead to greater authority on monetary or financial issues being passed to Brussels (point 5 above). This should help to neutralize any potential criticism from eurosceptic voices in the UK parliament.

The other perceived cost of this move is loss of influence and prestige in the IMF. But the actual costs of merging European representations are relatively low for at least three reasons. First, as has been demonstrated in a number of studies, the divergence in preferences on IMF lending among large European states is limited.[6] Second, as coordination mechanisms among Europeans in the IMF already exist, the move would only serve to formalize that existing *de facto* coordination. Third, the UK, unlike smaller European countries that have seats in the IMF, can exercise power on financial issues in numerous other international fora. The G8 and G20 are just two examples.

No specific potential proposals on changes to European representation are outlined here. But it is worth noting that as IMF constituencies have no uniform rules about leadership and elections,[7] there are several possible realignments that would maintain UK leadership of a European constituency. To reinforce the earlier point, achieving such realignment may be dependent on the UK leading on this issue, as an initiative from another European state (e.g. Germany) may result in a far more centralized role for the European Central Bank or the European Commission.

Conclusions

The UK should use its chairmanship of the G20 to take the lead on IMF governance reform by volunteering to give up its seat on the Executive Board. This action will certainly surprise many observers, will be a tangible announcement at a summit where expectations are running high, and will enhance the UK's credentials as a serious reformer of global governance while simultaneously affording it a number of benefits in terms of negotiation and material gains. If pursued in this manner, the costs are minimal. Allowing this inevitable aspect of IMF reform to go ahead without British leadership increases the risks for preserving UK interests in the Fund.

6. See Copelovitch, M., 'Master or Servant? Agency Slack and the Politics of IMF Lending', Working Paper, University of Wisconsin-Madison, 2006. Available online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1307414.
7. Lombardi, D. and N. Woods, 'Uneven Patterns of Governance: How Developing Countries are Represented at the IMF', *Review of International Political Economy* 13 (3) (2006), pp. 480–515.

Reform of the Financial Stability Forum: Four Considerations

Andrew Baker

Four considerations or rationales should inform the reform of the Financial Stability Forum (FSF). These are:

(1) *Realizing cross-sectoral potential* – the need to build on the original innovative institutional features and strengths of the FSF as a multi-agency forum with the capacity to facilitate cross-sectoral and inter-regulator dialogue, so as to enhance appreciation of the synergies that tie different financial markets and sectors together.

(2) *Bolstering sight lines and the field of vision* – the need to equip the FSF to consider not just questions of 'high' global finance, but also to ensure that its membership reflects a recognition that global financial stability is linked to and depends on the integrity and viability of 'everyday' credit practices and products, in ways that enable the Forum to respond to and anticipate problems in consumer and household finance that might have broader systemic implications;

(3) *Country representation* – the need to enhance the representation of important emerging markets and developing countries in the FSF;

(4) *Accountability relationships* – the need to clarify the accountability relationships between the FSF and other bodies;

My intention in what follows is not to go into the detail of the precise representation and numbers within the FSF, but to paint with a broad brush and identify guiding principles, rationales and objectives, which should the inform the work of the G20 working group on reform of the FSF.

Fully realizing cross-sectoral potential

The initial rationale behind the creation of the FSF in 1999, according to the G7 communiqué announcing its inception and to its creator Hans Tietmeyer, was to ensure that national authorities, multilateral institutions, relevant international supervisory bodies and expert groupings could more effectively foster and coordinate their responsibilities, pool information and develop early-warning indicators of crises. The FSF was an attempt to create a one-stop shop that brought a variety of systemically important national regulators and international regulators and bodies under one roof in a common shared space for dialogue and exchange, at least partially reflecting the ways in which different financial markets were becoming tied together with significant systemic implications. Joined-up governance (regulatory and market analysis) for the global financial system was the aspiration. In this respect, the FSF was a spectacularly good idea and an important institutional innovation – at least in terms of its conception. It has been less successful in overseeing the execution of these objectives. In the intervening period, not least in the context of the current crisis, the importance of inter-regulatory dialogue across sectors and an advanced appreciation of the synergies linking contemporary financial, credit and debt markets has become more, not less, important. The FSF as a cross-sectoral forum remains a good idea; it should be central to the response to the current crisis, but to date it has not realized its potential. The reasons for this underperformance need to be understood and addressed.

In part, each of the three following headings address some of the existing problems in turn, but FSF reform also calls for some serious soul-searching on behalf of those currently involved. What does each national agency contribute to the broader objectives of the FSF and what purpose does their participation serve? The FSF cannot afford to carry passengers. Positive, active contributions are required. Question marks remain over the number of finance ministry representatives in the FSF, for example, not least because many finance ministries have little in the way of regulatory reach, responsibility or expertise. In their reflections on the operation of the FSF, former participants Howard Davies and David Green conclude that the Forum has helped to educate ministries of finance on financial stability issues.[1]

But this observation raises the question of why the finance ministries are there in the first place if they have relatively little expertise or focus in this area. Is their presence now a luxury that can be ill afforded? Do they need to be directly involved in the FSF, or are they taking up valuable seats that would be better occupied by other agencies with specific regulatory responsibilities?[2] Would it be more efficient for the finance ministries to play a monitoring role of the FSF, one step removed from direct participation? These questions need to be answered candidly and openly. If the cross-sectoral potential of the FSF is to be realized, states need to debate and rethink which agencies would best represent them in the Forum, so as to create the best possible potential overview of the different markets contributing to overall global systemic financial stability and the best possible understandings of the relationships between these markets. Of course, it should be added here that there is a connection between the supervision of certain sectors, risk management strategies and macroeconomic stability. Global imbalances and their management through macroeconomic strategies affect the liquidity of different markets in different ways at different times. There is a strong case for saying that the FSF is the obvious venue for monitoring how global imbalances impact on market sectors, in a way that involves national regulators. In such instances there is an obvious case for representation from finance ministries of large countries that are important for the handling of global imbalances. It is less clear that smaller G7 countries should continue to send finance ministry representatives to the FSF.

Bolstering sight lines and fields of vision to include knowledge of everyday credit and financial products

The current financial crisis has highlighted the unprecedented relationships between everyday saving and borrowing and the capital markets we know as 'global finance'. Extraordinary transformations of global finance are intimately related to transformations in seemingly mundane savings and borrowing, while recent huge gyrations and disruptions have arisen out of ruptures in the ordinary payment routines of mortgagors.[3] Any body purporting to have responsibility for, or to contribute to, systemic financial stability needs to recognize these linkages, have the analytical capacity to examine them in greater detail, consider the regulatory implications of such linkages and assess their implications for systemic stability. In the context of the current crisis, focusing solely on securitization, risk management techniques, credit rating agencies, the activities of hedge funds and structured investment vehicles, prudential oversight, the dangers of procyclicality (Basel II), or what we conventionally conceive of as 'global finance' will constitute a job only partly done.

Global bodies such as the FSF need a better appreciation of how everyday credit practices and procedures relate to some of the products and activities listed above. This will require dialogue and relationships to be built with agencies involved in or overseeing these activities. That might involve greater outreach to, or powers for, the FSF to elicit testimonies and contributions from agencies in the United States such as the Federal Deposit Insurance Corporation, the Federal Trade Commission, the Department of Housing and Urban Development, the Federal Housing Association, and even Fannie Mae and Freddie Mac, and for these agencies to participate in FSF working groups on a selective basis. At the very least, a clear dialogue and relationship between these kinds of bodies (and national

1. Davies, H. and D. Green, *Global Financial Regulation: The Essential Guide* (Cambridge: Polity Press, 2008), p. 118.
2. The Securities and Exchange Commission represents the US in the FSF but has a far from exhaustive regulatory reach, while the Commodities Futures Trading Commission remains excluded, as is the Options Clearing Corporation. The Treasury Department, with little in the way of regulatory responsibility, participates in the FSF. The European Commission has expanded its regulatory role in Europe, but still does not participate in the FSF. The Commission could play a key role in rationalization of European representation in the FSF. My purpose here is simply to ask the question whether the current membership in terms of national representatives in the FSF is the most rational, efficient and effective that could be achieved.
3. Langley, P., *The Everyday Life of Global Finance: Saving and Borrowing in Anglo-America* (Oxford: Oxford University Press, 2008).

equivalents elsewhere) and the FSF ought to be established. The current crisis has revealed that the activities these agencies are involved in, or have oversight of, have global reverberations, yet they are excluded from the global financial architecture and global policy dialogues. It has also revealed that this situation is unsustainable, and efforts at reform should attempt to address this by inserting their voice, perspective and expertise into global debates, in some way, shape or form. The multi-agency nature of the FSF makes it the obvious venue for such efforts. Failure to address this issue will constitute a wasted opportunity.

Country representation

Country representation is the most obvious and publicized issue facing FSF reform. G7-centric membership of the FSF is unsustainable, and damages its legitimacy, credibility and reputation. It is important that systemically important countries become FSF members. China, whose banking sector accounts for 9 per cent of the world total and whose banks are increasingly active internationally, should be given representation on a par with the biggest countries. Generally, it is important that the systemic significance of different locations is monitored and that the FSF shows a willingness to adjust its membership in recognition of the changing importance of different financial centres such as Mumbai, Dubai and São Paolo. The effectiveness and relevance of the FSF will be enhanced by such a stance.

Clarifying and specifying accountability relationships

Accountability relationships represent an enormous and important challenge for the FSF, but one that could be obscured by the clamour for emerging-market representation. This issue touches on many of the problems that have prevented the FSF from realizing its full potential. The real value added of the FSF is as a cross-sectoral, inter-regulator space (not as an out-and-out apex forum like the G7 or G20). It has the potential to act as a knowledge-generation network by enhancing understanding of the linkages and synergies between different financial markets and the implications of this for systemic stability. It can do this by tracking and monitoring market developments and innovations that have cross-sectoral implications (including liaising with market participants and experts), identifying areas of systemic vulnerability by preparing targeted reports on specific issues, particularly those of a cross-cutting, cross-sectoral nature. One of the laments of former participants in the FSF is that after an initial period of quite intense activity, the FSF was prevented from commissioning its own work and simply reported on developments going on elsewhere.[4] The FSF should be given a clear mandate to identify areas in need of urgent attention and where collaborative work between different regulators could usefully be undertaken, and then convene inter-regulator working groups to do so. This might allow the FSF to carve out a distinctive position and integrate the various perspectives of a diverse membership, something it has largely failed to do thus far.[5]

Institutions such as the Basel Committee, the International Organization of Securities Commissions (IOSCO) and the International Accounting Standards Board (IASB) have jealously guarded their independence, have engaged with the FSF somewhat selectively and generally have regarded it as something of a sideshow. The FSF should be given a formal mandate to commission individual and collaborative work from these bodies, to identify priorities for them, based on its own cross-cutting findings. The FSF should also be made formally accountable to one of the finance ministers' and central bankers' forums, probably the G20 now that the G7's status as an apex forum is being challenged. This would entail reporting and testifying to ministers and their deputies, while giving the G20 a formal agenda-setting or directional mandate that would allow it to set priorities and deadlines for FSF work.

While the FSF should be encouraged to commission its own work and identify its own priorities, for reasons of

4. Davies and Green (2008).
5. Ibid.

accountability and legitimacy it would make sense if proposed agendas and initiatives were formally approved and endorsed by the G20. The work undertaken by the FSF would ideally enable it to identify vulnerabilities and predict or anticipate problems of a potential systemic nature. This could involve a colour-coded system of warnings about vulnerabilities to indicate to the G20 the urgency of issues and the type of remedial action required.

Finally, the FSF should send delegates to the IMF and the World Bank to disseminate the findings of FSF reports and work to their staff. These two bodies should be mandated to respond to FSF work and have an obligation to adjust their own assessment (Reports on the Observance of Standards and Codes and Financial Sector Assessment Programmes) and technical assistance programmes in ways that take into account the priorities identified by the FSF work on vulnerabilities. The FSF should also be given a means to feed into and inform the IMF's Global Financial Stability Report. The FSF should not be able dictate to the IMF and the World Bank, but they should be required to take account of it as an information and knowledge resource.

3. Emerging Issues for the G20

As the crisis has continued to unfold in the months since the G20 Summit in November 2008, certain macro-economic and financial issues not addressed by that meeting now appear at the top of the agenda with respect to both national and broader G20 efforts. This section looks at the ongoing global imbalances, exchange rate mechanisms and the role of emerging economies in the new financial architecture, as well as the risks of increasing trade and financial protectionism as global demand is collapsing.

Executive Summary

Paola Subacchi

As a result of economic and financial hardship, the limits of financial globalization and the tension between domestic agendas and global issues have emerged. Like trade, the exchange rate is both cause and effect of such tension. Much political activity has been directly or indirectly shifted towards the exchange rate in ways that imply new economic and political divisions. Fixing the exchange rate in a world of mobile capital implies forgoing national monetary policy autonomy in favour of greater certainty about the value of the currency. And this raises problems of international policy cooperation.

This section specifically deals with trade and the exchange rate, two issues that are not on the G20 agenda, but that constantly creep out. The section puts together heterogeneous contributions that nevertheless have a common thread in that they look at the 'big picture', rather than focusing on some elements of it. The debate on the crisis has so far been too fragmented, failing to see all the interdependencies in the macro picture and in policy. These contributions also recognize that much of the current crisis was caused by the build-up of global trade and financial imbalances. All, therefore, call for urgent and coordinated corrections to macro-economic policy. An injection of funds to revive trade credits is deemed to be particularly critical.

Protectionism features prominently throughout the section. All authors note troubling trends in this direction over the last year, although none regard them yet as a major contributory factor to collapsing global trade. All, however, see very considerable scope for protectionism to contribute to a second round of falls in trade volumes which feed back to global demand and to the financial sector, making recovery highly unlikely even in the medium term. Uri Dadush, in particular, draws attention to the fact that almost all members of the G20 – notably the largest members including the US, China, the EU, India and Russia – have disregarded the pledge to keep open markets made at the G20 summit in November 2008.

Fredik Erixon and Jim Rollo both stress the potential for WTO-legal protectionism to damage world trade. Whether it be through raising applied tariffs to the bound level (major emerging economies – though not China – could potentially raise tariffs between two- and fivefold in this area) or, as Rollo notes, through antidumping and countervailing duties, the use of various safeguard clauses or measures aimed at protection of the environment increases the risk of protectionism. Agreement to a standstill on the use of such *WTO-legal* measures would constitute an important strengthening of the commitment to a standstill on *WTO-inconsistent* measures at the November 2008 summit. All authors see the need for a strong WTO surveillance function to hold G20 members to their commitments.

Tackling protectionism seems almost a natural fit for the G20, so it is no surprise that most contributors see it as possibly the most significant outcome that could emerge from the London Summit. But the fit is less obvious with regard to negative spillovers resulting from exchange rate misalignments. Stephen Jen is adamant that exchange rates are not one of the issues that the G20 needs to address as a significant structural realignment in the world's external imbalances unfolds. But if we take the view that the G20 should address structural issues as well as short-term ones, then it should set the appropriate framework for some multilateral discussion on the international monetary system. Both Paola Subacchi and Jim O'Neill agree on the need for a smaller caucus to discuss exchange rate misalignments and global imbalances. This group should include, as minimum, the US, a Eurozone representative, Japan and China (Jim O'Neill), or be expanded to include the two countries with the largest foreign exchange reserve accumulation after China and Japan (Paola Subacchi).

Trade and the Crisis: Immediate Challenges and Long-term Threats

Jim Rollo[1]

World trade threatens to implode in the short term as the crisis unfolds. Trade credit has dried up alongside other credit circuits. Even more importantly, the credit crunch has turned into a sharp contraction in real demand worldwide, carrying trade with it. G20 governments must act at the London Summit to coordinate a global impetus to demand and to kick-start trade credit. They must also prevent increased protectionism making a very bad situation catastrophic by freezing new protectionist measures (including WTO-legal measures) and opening themselves to WTO-led surveillance of their trade policies while the crisis lasts. In the longer term the depth of the crisis threatens the model of export-led growth that has brought billions out poverty since 1950. This contribution explores what needs to be done to minimize the long-term costs of getting out of the hole the world economy has fallen into.

The fall in world trade

Following the G20 Summit in Washington in November 2008 the economic situation has been getting worse by the day. The decline in world trade that emerged in the third quarter of 2008 has accelerated. The picture is messy but the following facts give a snapshot of the situation:

- On 9 December 2008 the World Bank forecast a 2.1% fall in world trade in 2009, after an overall 6.2% rise in 2008.[2]
- Also in December, the IMF updated its World Economic Outlook forecasts and suggested that world trade and production shrank by 42% and 15% annualized respectively in the three months to November 2008. By contrast, Kindleberger (1986)[3] estimated that between 1929 and 1930 the fall in world trade was 19%.
- Data for the month of December suggested an accelerating decline, with monthly drops in exports reported by China (-2.8%) the US (-6%) and the UK (-3.7%) by value.
- Korean exports suffered a 12% fall 4th quarter on 4th quarter.
- Japan reported a 44% fall in exports year on year in January 2009 following a fall of 35% in December 2008.
- China reported a 17.5% fall in exports by value year on year, and a 42% fall in imports in January (export prices reportedly increased by 2.3% while import prices fell by 10.6%). February data were even worse than expected, with exports falling a further 25.7%.[4]
- In January 2009 Pascal Lamy reported to the WTO membership that even though year on year 2008 trade was up on 2007, there had been a worldwide decline in trade in November.[5]
- Brazil had hoped to be spared the worst, given the lower export share of its output than for many emerging economies.[6] But by February monthly exports had fallen by a quarter to \$9.6bn against \$12.8bn a year before, though clearly much of this

1. This contribution draws on a forthcoming Chatham House Briefing Paper on the same topic, written jointly with my colleague at the University of Sussex, Peter Holmes. I am grateful for the many insights he has given me but Peter has no responsibility for this version; all errors and judgments are my own.
2. http://web.worldbank.org/external/default/main?contentMDK=20665751&menuPK=3023135&theSitePK=612501&pagePK=2904583&piPK=2904598.
3. Kindleberger, Charles P. (1986), *The World in Depression 1929-39* (Berkeley: University of California Press, 2nd edn), Ch. 8, Figure 10.
4. *Shanghai Daily*, 11 March 2009.
5. Report to the TPRB [Trade Policy Review Board] from the Director-General on the Financial and Economic Crisis and Trade-Related Developments , 23 January 2009, http://www.tradeobservatory.org/library.cfm?categoryID=428.
6. Bloomberg, 2 March 2009, http://www.bloomberg.com/apps/news?pid=20601086&sid=aVcyiuBI_xGQ&refer=news.

was due to prices. Brazilian industrial production has been dramatically affected, falling by around 12% in December.[7] Some analysts attributed this to a fall in domestic investment.[8]

- Meanwhile 4th-quarter German GDP contracted at an annual rate of over 9% and Japanese GDP by more than 11%, reflecting the impact of lower exports on output.
- In mid-March the World Bank released a briefing that predicted that 2009 would see the biggest drop in world trade in 80 years.[9]

These falls are driven primarily by the drop in demand in the OECD countries in particular, and by the drying up of trade credit as financial markets seized up. Protectionism, while on the rise, is not yet the driving force of this decline; but the threat of subsidy wars is real, with support for the auto industry in the lead.[10] So the immediate challenge is to stop and then reverse the decline in demand.

The fall in trade is important in two respects: first, trade is a bellwether of the wider economy and hence of the crisis. Second, trade fluctuations first follow and then amplify fluctuations in output and demand – the more so if countries respond to the crisis with beggar-thy-neighbour trade and exchange rate policies. This trade policy-driven amplification of the fall in output is what Kindleberger[11] identified as a key feature of the Great Depression and is the fear shared by many economists.[12]

It is important for the G20 to acknowledge that there are many WTO-legal means of increasing protectionism and to forswear those as well. Raising applied tariffs closer to bound levels, increased use of antidumping or countervailing duties or safeguard measures, or appeal to environmental protection to justify trade barriers would all contribute to deepening the global downturn. These commitments to standstill must be backed by WTO-led surveillance.

Failure to complete the Doha Development Agenda is a dangerous signal of policy coordination failure

The second important news since the G20 November summit is the abject failure of trade ministers to get the Doha process back on track, despite direct instructions from the G20 leaders in Washington to meet in Geneva in December 2008 in order to do so.

Success at that point would not have changed much directly or soon. Any quick impact on trade requires coordinated macro-economic policy responses to increase global demand. But the symbolism of an agreement in the WTO – which is, after all, the pre-eminent organization of global economic governance – cannot be underestimated. Moreover, the symbolism of continued failure is little short of catastrophic. If the nations of the world, in the face of the greatest peacetime economic crisis since 1929, cannot complete a negotiation already more than seven years in the making and by most assessments unambitious, what chance is there to negotiate policy coordination – let alone the radical changes to global economic governance and regulation required to repair the damage already initiated by the crisis and help guard against future crises?

What should happen in London?

The trade agenda remains the same now as at the G20 summit in November 2008 but it is even more urgent for the G20 to act at the London summit:

- on falling trade volumes;
- by finding funds for trade credit;
- by agreeing a concerted, coordinated and larger monetary and fiscal stimulus than hitherto.

7. 'Output sank 12.4 percent month-on-month in December', http://uk.reuters.com/article/marketsNewsUS/idUKN0349650920090203?pageNumber=1; see also http://www.ibge.gov.br/home/presidencia/noticias/noticia_visualiza.php?id_noticia=1310&id_pagina=1.
8. *Financial Times*, 11 March 2009.
9. *The Guardian*, 10 March 2009.
10. See contributions by Erixon and Stern in this report for details.
11. Kindleberger (1986).
12. www.voxeu.org/reports/protectionism.pdf.

To prevent protectionism accelerating the downturn, the G20 should:

- make a public and high-profile recommitment to a freeze on new protectionist trade policy measures, including explicitly on WTO-legal measures (November rhetoric on trade was unclear on this issue) and on subsidies;
- Task the WTO, with help from the IMF and World Bank, to monitor G20 trade policies;
- Send trade ministers back to Geneva to finish the Doha Development Agenda – if necessary take their passports away and lock them in a room until they agree.

The credit crunch: a threat to export-led growth as a development strategy

There is a tendency for the policy implications of trade to be treated at the national and micro-economic level. But there is a two-way interaction between trade and the macro-economy at both national and global levels.

Export-led growth has propelled billions out of post-conflict devastation and poverty by generating historically unprecedented rates of growth. It has also, however, contributed to major instabilities in the global economy, mainly via persistent undervalued exchange rates and consequent global imbalances. Historically, the persistent German trade surplus in the 1960s contributed to the failure of the Bretton Woods system of exchange rate management; the persistent Japanese surplus in the 1980s almost led to an outright trade war with the US and culminated in the episode of policy coordination around the Plaza and Louvre accords; and now the huge accumulation of foreign exchange reserves in East Asia since the late 1990s has contributed to the current crisis. Net importers are and were to blame too as domestic policies were too loose in all of these episodes, but creditors cannot walk away from their responsibilities either.

A worst-case scenario

This is the deepest crisis so far and global imbalances are at the heart of the problem, both as symptom and as cause. Sustained protectionism and competitive devaluations to boost domestic production in net deficit countries remains a real threat. If that were to happen there would be no consumer(s) of last resort function to sustain export-led growth at the rates we have seen since 1950. This scenario threatens a structural slowdown in world trade and output growth. Such a scenario would leave a huge number of new entrants to the global labour market at risk of dire poverty, as the world population surges towards 10 billion over the next generation. The resulting political instability this could stimulate is a frightening prospect, not least when combined with the stresses that could be induced by global warming.

A new global settlement

The degree of policy coordination required to prevent a collapse in world growth rates points to the potential need for new global system. Such a system needs agreed rules or a hegemon. This will not be easy. The Bretton Woods system had both and took twelve years from the bottom of the depression and a world war to design and agree. Any new system will require at least as much commitment in a world of much greater political complexity. Such a system must provide guarantees of open markets, stable macro-economic policy and disciplines to curb the emergence of unsustainable imbalances that impact on importers and exporters. To be effective and legitimate, any new system cannot just be an escape mechanism for the US or any other big economic power to force the costs of its domestic adjustment on to others. It will need to be managed by a new G5/G7 (US, Eurozone, China, Japan, India to reflect economic weight and population, plus Brazil and South Africa or Nigeria because of their regional importance). No major economy can be exempt from monetary and fiscal disciplines if the global system is to resume anything like business as usual.

Conclusions

It is imperative to ensure recognition that shrinkage in global trade is a macro-economic problem that needs macroeconomic solutions, and that the allocation of action among actors as well as instruments must be coordinated.

For the longer term the world needs a set of rules on global coordination of macroeconomic policy that smooth the adjustment of the global economy to the emergence of new trading powers and spread the burden of adjustment among creditors and debtors. The lesson of the 1930s is that all nations will become more inward-looking economically and will resort to beggar-thy-neighbour economic policies without such rules.

Failure to move on such rules now will be measured not just in terms of the immediate recession or depression but also in terms of the lost ability of future billions to emerge on the world market and grow their way out of abject poverty. Policy failure now will pull up the ladder on the poorest for decades and possibly generations.

Mounting Protectionist Dangers and G20 Responses

Fredrik Erixon

The global economic crisis has spawned fears of rising protectionism, particularly about a repeat of the tit-for-tat protectionism of the 1930s. Spiralling protectionism then helped to turn a financial crisis into a decade-long depression, and governments had to spend a few decades negotiating in the GATT and other international organizations to undo the protectionist measures.

Yet these fears have not yet materialized. According to the World Trade Organization and its recent survey of protectionist measures in the face of the economic crisis, there is not much evidence of a sharp rush to adopt them.[1] Only a handful of countries increased tariffs during 2008 (Argentina, Brazil, Ecuador, India, Indonesia, Russia and Turkey),[2] and only a limited number of goods were subject to increased tariff protection.[3] None of these measures pose systemic threats to the world economy or to the integrity of the world trading system.

Nor is there reason to believe a malign scenario of spiralling tariff protectionism to be an imminent threat. Certainly, some other countries will increase tariffs to ease conditions for companies suffering from contracting demand. But such tariff hikes are not likely to trigger retaliatory actions, or to cover goods that are significantly traded. There are two restraining factors.

First, countries have bound their tariffs in WTO agreements and understand they will be taken to dispute settlement if they raise tariffs above these limits. A number of emerging countries with significant 'tariff water' – the difference between the bound levels and the applied levels – can raise tariffs without violating WTO commitments. Some emerging markets have already made use of the room for WTO-compliant tariff hikes; others are likely to do so as the effects of the crisis on output and employment grow worse. Table 1 indicates in what countries that may happen.

Table 1: Tariff water in emerging markets

	Tariffs on manufactured imports		
	Average bound tariff (%)	Average applied tariff (%)	Tariff water ratio
China	9.14	8.96	1.02
India	34.94	16.44	2.13
Mexico	34.91	13.33	2.62
Brazil	30.79	12.63	2.44
Turkey	17.03	4.69	3.63
Indonesia	35.55	6.75	5.27
Saudi Arabia	10.50	4.81	2.18
South Africa	15.72	7.85	2.00
Thailand	25.55	8.17	3.13
Argentina	31.84	12.57	2.53

Source: WTO Country Profiles

Second, countries with a significant participation in world trade cannot raise tariffs on a grander scale without damaging the competitiveness of their home firms. A significant portion of all trade today is trade in parts and components, or input goods, and companies have fragmented their supply chains to such an extent that it is difficult to trace the origin or nationality of a particular good. Advanced economies and emerging markets are densely integrated through such production networks. Imports are needed in order to export, and new tariffs on input goods will adversely affect profitability and output higher up in the value-added chain.

1. World Trade Organization, 'Lamy: "We must remain extremely vigilant"', news item, 9 February 2009, available on WTO website: http://www.wto.org/english/news_e/news09_e/tpr_09feb09_e.htm.
2. Trade remedies such as antidumping are not accounted for, as such measures are targeted against specific countries/exporters.
3. Ecuador, however, has imposed tariffs on 900 items.

Yet these two constraining factors do not prevent all forms of protectionism. WTO agreements are more powerful against tariff hikes than other forms of protectionism, e.g. non-tariff barriers and state aid to companies. Patterns of supply-chain fragmentation limit the temporary mercantilist value of a tariff increase, but they do not have the same effect on trade-distorting subsidies to domestic firms. Non-tariff protectionism is often more damaging than tariffs. Tariffs are quantified and companies can calculate their margins and profitability of trade. Non-tariff measures are often opaque and foreign firms have difficulty in assessing the cost such measures impose on existing or potential trade. The uncertainties are bigger.

It is this form of protectionism – creeping rather than spiralling protectionism – to which governments are now succumbing amid the economic crisis. It builds on protectionist trends that were under way long before the crisis hit in September 2008. Efforts by the G20 to limit protectionism and its damaging effects should focus on this trend of creeping protectionism.

Creeping protectionism

Current protectionist trends are similar to those in the 1970s and 1980s. In the 1970s, oil-price hikes and other shocks triggered inward-looking, mercantilist policies, not least in Europe and the United States. Immediate policy responses were not massively protectionist: there was no equivalent of the 1930 Smoot-Hawley tariff.[4] But escalating domestic interventions exacerbated economic stress, prolonged stagnation and, not least, spawned protectionist pressures. Industry after industry, coddled by government subsidies at home, sought protection from foreign competition. The result was the 'new protectionism' of the 1970s and 1980s.

Then, as now, manufacturers of gas-guzzling cars in America faced bankruptcy. The US Congress bailed out Chrysler in 1979. By then the British government had already bailed out Rolls Royce and British Leyland, and Renault was saved by French taxpayers shortly after President Carter signed the Chrysler bailout. Several other sectors (wood and timber, energy and minerals, railways, airlines, shipbuilding) received government subsidies in the 1970s. Many companies were nationalized.

Policies such as 'voluntary export restraints' (VERs), 'orderly marketing arrangements' and other mostly non-tariff barriers were deployed to 'manage trade'. The sectors that received subsidies at home also got protected from foreign competition. Through the 1980s, American car manufacturers were protected by VERs that restricted the number of Japanese cars exported to the US. Europe negotiated a similar agreement with Japan in 1983. To further restrict Japanese exports, some European governments imposed 'local-content requirements' on the cars produced in Europe by companies such as Nissan and Toyota. Many other sectors, including semiconductor and videocassette recorder manufacturers, were also protected by VERs or similar measures. The French government even demanded that Japanese VCR imports enter France via Poitiers, a town hundreds of miles from the nearest port.

Many references could be made to trade-distorting subsidies, increased non-tariff barriers and other creeping protectionism in the 1970s crises. Similarly, in a few years' time we will be able to produce an equally extensive analysis of measures undertaken by governments in 2008–10. The process has already begun.

Governments around the world have bailed out domestic banks and automotive industries. We are not even at the end of the beginning; more subsidies will be handed to ailing auto manufacturers and other sectors are lining up for direct government support. State-aid rules in the EU have been relaxed and certainly enabled suspicious state aid to pass the Commission's examination. The air is thick with governments' nods and winks to banks to lend at home, not abroad, and to car companies to ensure that their subsidies are spent on production and employment at home, not abroad. One hidden part of the United States' bailout of its banks is a restriction on firms to apply for H-1B visas (to employ specialist foreign workers). Other countries have not gone as far as to impose new restrictions on labour migration, but political leaders have echoed calls for 'British-jobs-for-British-workers'-style views.

'Buy America' provisions in government procurement have been attached to the US fiscal stimulus package. Other

4. See contribution by Uri Dadush for details of the impact of this tariff.

governments, for instance Spain and Sweden, have encouraged people to buy nationally produced goods. Government procurement has also been a favoured measure to support domestic manufacturers in Asian countries that are not members of the Government Procurement Agreement in the WTO. Chinese provinces and Indonesia, for example, have singled out domestic steel mills as favoured subjects. Several Chinese provinces have gone much further. In January 2009 the local government in Hunan introduced directions to government offices to buy passenger vehicles and raw materials, including medicines, made or sourced in the province. Non-tariff barriers have also increased in some sectors – from Belgian chocolate and Dutch eggs (China) to toys (India) to auto parts and TVs (Argentina). Apart from introducing new sectoral non-tariff barriers, Indonesia has also limited the number of import entries.

Creeping protectionism was surfacing before the crisis began and involved other policies than those mentioned above. Antidumping actions have been on the rise again for some time. Global antidumping took a big jump in the first half of 2008, and estimates show the increase continued in the second half.[5] 'Standards protectionism' has proliferated in agriculture and manufacturing, and increasing talk of carbon-based tariffs has magnified protectionist threats dressed up as environmental policy. 'China-bashing' is getting worse, with accusations of 'unfair trade' linked to 'currency manipulation' and bilateral trade deficits. Calls for corrective measures against China are likely to increase as the new US administration has officially labelled China a currency manipulator. In the last few years there has been an increase in the number of investment restrictions and of unfavourable laws on cross-border investment. Countries as diverse as China and France have singled out strategic sectors and national champions to be protected from the embrace of globalization. Protectionist tendencies can be seen everywhere in the energy sector.

A mission for the G20

What can the G20 do to block current protectionist trends?

- ***Avoid sweeping, shallow and non-committal pledges to fight protectionism***. At the Washington summit in November 2008, G20 members agreed to avoid protectionist measures for a year and to instruct their trade ministers to agree on Doha-round modalities before the end of 2008. It took only a few days before tariffs had been increased by a G20 member, and at least 25 per cent of members have increased tariffs since November. At least two-thirds of the membership have imposed measures that are clearly protectionist, even if they are not forbidden by any WTO agreement. Making pledges you are likely to dishonour is a good way of undermining the entire legitimacy of the G20.
- ***Acknowledge the real protectionist threats***. Governments today are fighting the wrong enemy. They argue for a battle against a 1930s-style scenario of spiralling tariffs, whereas such a development is highly unlikely. This Maginot line of anti-protectionism is morally admirable, but it prevents governments from fighting actual protectionism or protectionist threats. Similarly, governments need to acknowledge that the current expansion of fiscal spending – regardless of its merits as counter-cyclical policy – is a potential source of escalating protectionism.
- ***Establish a 'ceasefire agreement' on key protectionist measures: tariffs, trade-distorting state aid, and buy-national policies***. Other measures would ideally be part of a ceasefire agreement too, but it is not political feasible to cover, for example, increased use of antidumping measures. The important task now is to sort out the really bad apples – those that can trigger tit-for-tat developments.
- ***Task a smaller group of countries to propose to the next G20 summit guidelines on how to prevent protectionist threats*** from materializing, and to progress multilateral agreements that strengthen disciplines on the favoured tools of protectionism. This group could include, say, China, the EU, Japan and the United States. Cooperation is needed, but the G20, and even more the WTO, is too unwieldy to allow for clear proposals and leadership from the big countries to emerge from summits or unprepared plenary sessions.

5. See Elisa Gamberoni and Richard Newfarmer, 'Trade protection: incipient but worrisome trends', VoxEU, 4 March 2009, http://www.voxeu.org/index.php?q=node/3183.

Resurgent Protectionism: Risks and Possible Remedies

Uri Dadush[1]

As the global financial crisis intensifies, world leaders are facing growing political pressure to enact protectionist measures. Since the inaugural G20 summit was held in November, nearly all G20 members, including the United States, the EU, China, India and Russia, have taken steps intended to protect their own producers.

While the impact of measures enacted so far is small, the risk of a devastating resurgence of protectionism is real. A resurgence of protectionism today would generate even greater losses than it did in its last surge during the Great Depression, when tariffs were much higher at the outset than they are today and countries were less integrated through complex international production chains.

Counter-cyclical policies and banking bailouts are absolutely necessary to contain the crisis. But they also imply a much expanded role of the state in – and therefore an expanded risk of politicization of – economic decisions. Even when support measures are intended to mitigate the downturn, their unintended effect is often to protect, and such measures can therefore easily be misinterpreted by other governments as protectionist. If, as is unfortunately quite possible, the crisis continues to deepen and becomes even more protracted, the pressures to protect could become overwhelming.

Policy-makers at the coming G20 meetings need to take important and urgent steps to avoid backsliding or, worse, a trade war. Establishing a monitoring function with teeth in the WTO is an obvious immediate step. The G20 must also strengthen the world trading architecture so as to avoid backsliding during future downturns. Reforms of the WTO, not only the World Bank and the IMF, should be the object of a dedicated G20 working group in preparation for future meetings.

Rising risk of protectionism

Intensity of the crisis: Experience of previous crises suggests that the pressure to protect grows in step with the speed, depth and duration of the downturn. The impact of the current economic downturn has been momentous, not just in scale, but also in the rapid pace of its transformation from an isolated US and West European financial crisis into a global meltdown pervading all sectors. In the fourth quarter of 2008, world industrial production fell at a 20 per cent annual rate; these declines have so far continued unabated in the first quarter of 2009. Jobs are being shed in every country; the International Labour Office expects 50 million workers around the world to become unemployed owing to the global recession. The dearth of trade finance, combined with reduced global demand, has had an immediate and significant impact on global trade, which the World Bank predicts will contract in 2009 for the first time since the early 1980s.

The effect of the crisis on developing countries is very recent but promises to be severe in the aggregate, and catastrophic in a few. A sharp decline in external finance to developing countries has already occurred and is predicted to get much worse in 2009. East European countries, many of which have large current account deficits that circumscribe the space for fiscal and monetary policy, lie most exposed. Some are at direct risk for default unless their

1. This contribution was prepared with excellent support from Lauren Falcao, Junior Fellow at the Carnegie Endowment. Merit Janow and Richard Newfarmer provided valuable suggestions. A longer and revised version of this paper is available on the Carnegie website.

neighbours to the west and the international financial institutions provide direct assistance.

Though most forecasts predict recovery sometime in 2010, the unprecedented nature of this episode makes these projections exceptionally uncertain. Recessions arising from financial crises tend to last two years longer than recessions driven by other factors. Assuming this crisis conforms to this trend, by 2010 the US would be only about one-third to one-half of the way through its recession, while in the vast majority of other countries, where the recession is more recent, recovery would be likely to take even longer. Further, lessons from past financial crises indicate that today's global downturn may continue to deepen. Peak to trough decline in GDP during financial crises is most typically around 5 per cent.[2] The Great Depression saw a decline of 25–30 per cent of GDP. To date, the decline in US and European GDP from peak is probably no more than 2–3 per cent. Despite the damaging and pervasive effects that this crisis has already had on the world economy, it is as yet relatively short-lived and shallow in comparison with past crises.

There are reasons to think policy-makers have learnt from past crises, and that this episode will be better managed than most, but there are also reasons to think that underlying problems – both those that caused the crisis and those that limit the scope for policy response – run deeper than in past crises. Debt levels as a share of GDP in the US and the UK have never been higher.[3] New tools such as securitization, credit default swaps and derivative contracts have made financial intermediation more complex than ever before.[4] Capital mobility – which is associated with increased crisis frequency – is at an all-time high.[5] Furthermore, whereas during most crisis episodes countries could rely on world trade demand for support, in this case that demand is fading rapidly.

Growing role of the state and weak WTO disciplines: The size of today's government intervention is unprecedented; the planned US financial bailout packages alone account for 17 per cent of GDP. While the size of the intervention does not by itself create room for protectionism, its non-neutral nature does. Support to domestic banks, finance companies of industrial conglomerates and the auto companies is clearly discriminatory. Furthermore, two-thirds of the most recent US stimulus package is allocated to infrastructure, science, health care and other initiatives. Within each of these categories, policy-makers, not the market, decide which groups will benefit from an injection of government money and which will not, incentivizing groups to lobby to receive a disproportionate share of the benefits. Groups have been particularly successful in lobbying for funds to be allocated to national companies to preserve employment opportunities for citizens. For example, the 'Buy American' provision of the US stimulus package provides a 25 per cent competitive margin for US manufactured goods for all expenditures under the bill.

Even when stimulus packages require, as does the US bill, that provisions be consistent with the country's obligations under international agreements, policy-makers retain the flexibility to discriminate. For example, 75 per cent of iron and steel imports into the United States originate in countries that are not signatories to a relevant procurement code, under either the WTO Agreement on General Procurement or bilateral agreements.

There are many other opportunities to increase protection without breaking WTO law. Developing countries tend to have large gaps between bound and applied rates, and, for several goods, have no bound rates at all. Industrialized nations could withdraw their Generalized System of Preferences, which offers least developed nations lower tariffs than other nations. All nations are also permitted to raise compensating tariffs against a trading partner found guilty of dumping or of implementing distortionary subsidies. Standard-setting bodies have wide discretion. Finally, the WTO still has several salient gaps in its jurisdiction; for example, protectionist

2. Reinhart, Carmen M. and Kenneth S. Rogoff, 'Is the 2007 US Subprime Crisis So Different? An International Historical Comparison.' *American Economic Review*, 98(2) (2008), pp. 339–44.
3. Wolf, Martin, 'Why dealing with the huge debt overhang is so hard.' *Financial Times*, 27 January 2009.
4. See contribution by Robert Rosenkranz for fuller details of credit default swaps.
5. Reinhart and Rogoff (2008).

bailouts and investment restrictions are allowed in many sectors.[6]

Further, while the general expectation is that countries will abide by their WTO commitments, this obviously cannot and should not be taken for granted in the event of a trade war.

Protectionist measures are increasing: While protectionism so far has probably had only a modest effect on trade flows,[7] it is clear that countries are increasingly resorting to protectionist measures. Whereas the trend over the last two decades has been towards increased liberalization, since the financial crisis worsened in November, 55 of the 77 enacted trade measures around the world have been trade-restrictive.[8] Half of these measures are tariffs, which are employed primarily by developing countries that lack the budget to enact costly subsidies. Only a third of the 43 developing-country measures involved subsidies, while all 12 industrialized-country measures were subsidies. Other measures limiting trade included licensing requirements (e.g. Argentina), restricted entry (e.g. Indonesia), tighter standards (e.g. China), and outright bans (e.g. India).[9] Final evidence of protectionism can be seen in the increased number of antidumping complaints filed with the WTO, which, after years of decline, rose by about 15 per cent in 2008.

Of these measures, WTO Director-General Pascal Lamy finds that the most influential have been OECD countries' support to banks, other financial institutions and the automobile industry.[10] Subsidies for the auto industry now total some $48 billion worldwide, $42.7 billion of which is in high-income countries.[11]

Potentially large losses from protectionism: The potential losses from trade restriction could be huge. The Smoot-Hawley Tariff Act enacted in the early stages of the Great Depression present one estimate of what countries stand to lose by instituting protectionist measures. Following the Smoot-Hawley Act, the effective US tariff rate rose from 13.5 per cent in 1929 to 19.8 per cent by 1933, encouraging retaliation on the part of US trading partners. The combined effect of falling demand and increased protection led to US imports falling from $1.3 billion in 1929 to $390 million in 1932, while US exports fell from $2.3 billion to $784 million. Over the same period, world trade declined by 33 per cent, and the increase in both tariff and non-tariff barriers may have accounted for a little over half this decline.[12]

According to some estimates, Smoot-Hawley's impact on the US economy may have been relatively small, compared with the direct effect of falling demand.[13] However, this was probably due to the relative unimportance of trade in the US economy during this period. In 1929, imports accounted for only 4.2 per cent of GNP and exports only 5 per cent. Today, imports comprise over 14 per cent of GDP and exports 11 per cent. Average US tariffs today are also a fraction of what they were in 1929. Trade shares are much higher in other countries, and tariffs are on average less than a quarter of what they were in 1929. The effect of Smoot-Hawley is therefore a very low estimate of the potential impacts of protectionist measures today.

Another estimate of these impacts is provided by the International Food Policy Research Institute (IFPRI), which examines two protectionism scenarios. In the more modest scenario, countries raise their tariffs to their maximum rates applied during the period from 1995 to 2008. As a result, world trade decreases by 3.2 per cent and world welfare falls by $134 billion. In a more severe scenario in which countries raise tariffs up to their WTO bound rates, world trade decreases by 7.7 per cent and

6. Evenett, Simon J., 'No Turning Back: Lock-in 20 Years of Reforms at the WTO', in Richard Baldwin and Simon Evenett (eds), *What World Leaders Must Do to Halt the Spread of Protectionism* (VoxEU.org 2008).
7. Lamy, Pascal, 'Report to the TPRB from the Director-General on the Financial and Economic Crisis and Trade-Related Developments', JOB(09)/2 9 (2009).
8. Gamberoni, Elisa and Richard Newfarmer, 'Trade Protection: Incipient but Worrisome Trends', VoxEU.org. (2009).
9. Ibid.
10. Lamy (2009).
11. Gamberoni and Newfarmer (2009).
12. Madsen, Jakob B., 'Trade Barriers and the Collapse of World Trade during the Great Depression', *Southern Economic Journal* 67 (4) (2001), pp. 848–68. doi: 10.2307?1061574.
13. Romer, Christina D., 'What Ended the Great Depression?', *The Journal of Economic History* 52 (4) (1992), pp. 757–84.

world welfare drops by $353 billion. IFPRI also examines the ramifications of a failed Doha agreement, finding that the world will lose $336 billion in potential world trade if the negotiations fail.[14]

Who would lose the most from protectionism? All countries would be adversely affected by restraints on their exports or by measures that affected the overseas operations of their multinational companies. Not surprisingly, smaller countries or territories (such as Hong Kong) are typically the most open and most exposed. But large countries such as China and Russia have high export exposure as well, and both the Eurozone and UK have relatively high outward FDI stock as a percentage of GDP, making them vulnerable to retaliation from other nations closing their borders to investment or discriminating against existing foreign establishments. The US is among the relatively least exposed, with an outward FDI stock that comprises 19 per cent of GDP and exports that amount to only 11 per cent of GDP, but its absolute losses would be among the largest.

While the above analysis privileges the mercantilist perspective, by focusing on losses of export markets, welfare losses from countries' own import restrictions would be likely to outweigh losses resulting from new barriers erected by their trading partners. While specific interest groups can gain handsomely from protection, the main victims of protectionism are the countries that engage in it.

Policy recommendations 1: short-term risk mitigation measures

1. The most effective way to defuse protectionist pressures is to reignite economic growth quickly. Acting aggressively on the broader economic recovery agenda, including injecting fiscal and monetary stimuli, removing non-performing assets from bank balance sheets, and helping the most vulnerable countries and groups, is essential. But how this is done is also important. Stimulus and financial rescue policies should aim to be as non-distorting of competition, both foreign and domestic, as possible. Support measures should be temporary and have a clear exit strategy. Furthermore, in so far as the burden of economic recovery policies is shared across countries, and is seen to be fairly shared, it becomes easier to avoid beggar-thy-neighbour trade measures.
2. The moratorium on new trade restraints agreed at the inaugural G20 summit should be reaffirmed through to the end of 2010 and given teeth. This would include explicitly endorsing the WTO's enhanced surveillance role for the duration of the crisis, and requiring the G20 to report immediately all changes in applied tariffs and subsidies to the WTO Secretariat. The reporting requirement should also apply to all presumed WTO-legal measures under contingent protection, including safeguards, countervailing duties, and antidumping initiations and sanctions. The Secretariat would be required to report periodically to the General Council as well as to provide a written account as a background paper for future G20 summits.
3. International consultative groups should be established to monitor support to sensitive sectors, such as banks and automobile companies, to promote the minimization of trade-distorting effects and to encourage such supportive measures to remain strictly WTO-legal. The purpose of these groups would be to exchange information, improve transparency and agree guidelines.
4. The G20 should reaffirm its determination to bring the Doha negotiations to a successful conclusion by the end of 2009.

Policy recommendations 2: Longer-term measures to reduce the likelihood of a resurgence of protectionism in future crises

1. The overwhelming priority of the G20 over the next year should be to reignite economic growth and avoid the spread of protectionism, hence the recommendations above. However, just as thought is now being

14. Bouet, Antoine and David Laborde, 'The Potential Cost of a Failed Doha Round', International Food Policy Research Institute, Issue Brief 56, 2008.

given to strengthening the international financial architecture to prevent a recurrence of the financial crisis, including reform of the World Bank and the IMF, so consideration is required of how the international trading system can be strengthened to avoid a resurgence of protectionism in future crises. Since seven years of Doha negotiations have so far failed to produce even a modest improvement in multilateral disciplines, it is reasonable to ask how the WTO process can be made more effective. With this in mind, the G20 should endorse the launch of a working group to propose WTO reforms.

2. Near-term questions to be addressed by the working group should include:
   (a) how can the WTO's surveillance function be strengthened?
   (b) How can rules on state aid in the event of macroeconomic crisis be clarified and strengthened?
   (c) How can the membership of the plurilateral agreement on government procurement be broadened, ideally to cover the whole WTO membership?
3. Longer-term measures would relate to the functioning of the WTO as an effective negotiating body – one that, over time, can be realistically expected to reduce the rate of bound tariffs and subsidies (thus reducing the gap between bound and applied tariffs and subsidies), reduce the enormous room for discretion in trade in services, and also place tighter disciplines on contingent protection. There are a number of questions here. How can negotiations be made faster, more capable of accommodating diverse interests of members, and more successful in addressing today's most pressing issues? Should negotiations be increasingly based on plurilateral and sectoral agreements rather than on the single undertaking? How can the WTO draw on the energy of regional trading agreements, and better discipline and incorporate them, so as to make progress on overall trade liberalization?

A Grander, Greener Global Bargain: Generating Growth by Refocusing Trade Liberalization on Energy and Green Solutions

Paula Stern

The November 2008 meeting of G20 leaders in Washington, DC was convened to craft a response to the global financial crisis. President George W. Bush was still in office, with two months remaining. Since the November meeting, the financial crisis has become a spreading global pandemic and the entire global economic system is in serious peril. The April 2009 meeting in London is the opportunity for the G20 grouping of developed and developing nations that account for 90 per cent of world GNP and 80 per cent of world trade to address the crisis It is indeed a historic moment for President Barack Obama and other world leaders to reorder global priorities for the 21st century and harness market forces to revive, advance and spread economic prosperity. It is another chance, after many decades of delay, to finally link the energy and the environmental crises and start tackling them systematically and proactively. It is also time for a new generation of leaders to revitalize the institutions which were designed sixty years ago by leaders meeting in Bretton Woods, New Hampshire, and to adapt these institutions to today's hugely challenging tasks.

Since the end of the Second World War, global growth and poverty reduction have been premised on trade growth through greater market liberalization and adherence to the rule of law. Today, however, as job losses climb, pressure is mounting on governments in all countries to take protectionist trade measures that roll back market liberalization and compromise legal commitments based on principles of non-discriminatory national treatment. This contribution offers several concrete recommendations to the G20 for turning this crisis into an opportunity to coordinate global leadership in addressing the economic and trade crisis in such a way that the world's energy needs and environmental well-being are also considered. Linking these goals will help build political support at home to underpin any one nation's commitment to undertake multilateral obligations.

Economic crises, nationalistic measures and global political instability

At their November 2008 summit, the G20 leaders expressed the necessity of 'rejecting protectionism', promising that for '12 months, [they would] refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing World Trade Organization (WTO) inconsistent measures to stimulate exports.' That clear commitment, however, has not been kept. According to the World Bank, seventeen of the G20 nations have taken new measures that restrain trade or discriminate in favour of national firms.

A US example is the 'Buy American' clause of the American Recovery and Reinvestment Act of 2009, which President Obama signed on 17 February 2009. The final bill took some of the sting out of the originally drafted legislation by stating that the provision must be administered in a way that is consistent with US international trade agreements. The US government has yet to clarify whether money allocated under the stimulus plan to US state governments would be covered by the provision; currently 13 US states do not have procurement commitments under the WTO Government Procurement Agreement (GPA).

Even the toned-down version of 'Buy American' is the basis for concern that the clause, while WTO-compliant, still licenses discriminatory treatment against countries that are not signatories to the GPA – most prominently Brazil, China and India. Ironically, this could be an incentive for these prominent countries to sign up to the GPA. However, if other nations are less artful than the United States in drafting similar bailouts, their trading partners would be within their rights to retaliate by raising their bound tariffs to levels well above the applied/actual tariffs they may have in place today. In his report on 24 January 2009, WTO Director-General Pascal Lamy stated that the effects of raising these tariffs could cut the value of global trade by up to 8 per cent. The stakes are particularly high for developing countries that have pursued export-driven policies; they are the only countries experiencing continued, albeit anaemic, growth in 2009, in spite of the burdens from dragging commodity prices, slowing tourism and shrinking remittances.

In this recession, protectionist measures are likely to differ from the across-the-board tariff hikes that the United States imposed under the Smoot-Hawley Act of 1930 (which economists believe helped turn a deep recession into the Great Depression). While developing countries are deploying tariff measures that also provide government revenue, most protection is not as clear cut today. Instead, many developed and some emerging economics such as China are introducing domestic subsidies (so-called 'bailouts') which, like tariffs, are a common instrument that can distort trade. Because few of the 153 WTO members keep their commitments to notify the WTO biannually when they have adopted domestic subsidies, these constitute an opaque and underappreciated threat, and one that is more likely to come from the relatively richer countries that have more power to subsidize.

Other measures are likely to take the form of so-called 'contingency protectionism', including countervailing duty measures against subsidized imports, antidumping complaints and safeguard actions. These measures grew out of bargaining among negotiators during previous rounds of multilateral liberalization. They are legitimate temporary actions when executed according to WTO rules, but they have the same impact of reducing overall trade. As such, they increase global trade friction and together could swamp the WTO dispute settlement mechanism.

US unemployment numbers have reached a peak not seen for more than a quarter of a century – the last time the major economies engaged in such high-stakes trade skirmishes, if not actual trade wars. Today, the risk of global instability from trade wars is even greater. This is not just because this dual recession/financial crisis is the worst since the Great Depression. It is also because globalization has expanded, and so many more nations rely on trade for investment and growth. The increased complexities of global supply chains have further exacerbated the potential for unanticipated second- and third-order effects.

Economic turmoil in Latvia, Ukraine and Iceland has already rocked governments. When governments bend to domestic political pressure to resort to nationalistic measures, this can lead to tit-for-tat responses that weaken economies and can trigger even greater instability. Ominously, the linkage between national security and economic policy was highlighted by Admiral Dennis Blair, Director of National Intelligence in the US, in his February testimony before the Senate Select Committee on Intelligence: 'The primary near-term security concern of the United States is the global economic crisis and its geopolitical implications,' Admiral Blair emphasized. Because of these concerns, the Obama administration has asked the Central Intelligence Agency Director to include an Economic Intelligence Briefing in his daily White House report that highlights threats to world stability.

When the US faced a serious industrial recession in the 1980s, the major manufacturing giants in the auto and steel industries mounted successful protectionist campaigns which inspired industries including semiconductors and machine tools to do the same. Protectionism feeds on itself domestically as well as internationally. As a result of steel and auto protection last time, for a decade the world was saddled with so-called OMAs (Orderly Marketing Agreements) limiting auto trade between two of the world's great economic powers, the United States and Japan. In addition, the United States negotiated Voluntary Restraint Agreements (VRAs) with 27 nations on a wide range of steel products. The VRAs had morphed out of hundreds of subsidy and dumping complaints filed at the Department of Commerce and USITC (the US International Trade Commission) by US steel companies and workers. Steel users in America paid the price for this protection. They paid more for steel and lost manufacturing jobs to countries that paid less. Machine tool manufacturers took hits, and so did parts makers. Everyone paid.

Global economic leadership challenge to the new US administration and G20

President Obama's administration is surely cognizant of the leadership role that the United States must play to restart the US domestic economy. In his first months in office, the new President has managed to pass a domestic economic recovery stimulus package, increase financial help for banks and automobile companies, start an assistance programme for perhaps nine million families with shaky home mortgages, issue a blueprint for banking reform, and propose a budget plan. The G20 meeting in April will signal whether and how President Obama and the United States will step into the global economic leadership role that America has played since the dawning of the post-war Bretton Woods era.

What should President Obama and the G20 propose to propel the global trade engine, which has generated prosperity for sixty years? The answer: a grander, greener global bargain.

Recommendations for catalysing a sustainable trade agenda

The November 2008 G20 did not fully anticipate that the world would be gripped so rapidly by such a dramatic global economic recession. So its work programme was more focused on the financial crisis and architectural reform of the International Monetary Fund and multilateral banks. The November Declaration on Financial Markets and the World Economy does include a 'commitment to an open global economy'. However, the November pledge against taking protectionist measures could be used to generate deeper consideration of the role that the WTO can play both alone and in cooperation with the IMF, World Bank, and other multilateral banks.

Nor did the November G20 recognize that the crisis that threatened world stability the year before was driven by skyrocketing prices for food and fuel, and that it could happen again. The newly formed G20 is the forum that should acknowledge the linkage between energy, climate change, national security, trade, economic growth and instability, and take the lead to weave together a tighter, more coordinated, disciplined global trade agenda.

1. ***Anti-protection pledge***: The G20 should extend its November pledge against protectionist measures beyond its initial 12-month period and empower the WTO to monitor adherence and issue quarterly public reports.
2. ***WTO surveillance***: The G20 should task the WTO to monitor the industrial support programmes that its member states are undertaking. US and European support programmes for the automobile industry, amounting to at least $40 billion and growing, are the most prominent, but measures have also been taken by China and Japan.

   The WTO can play a bigger role in making transparent and disciplining the execution of these support programmes or 'bailouts' to limit damage to the world trading system. According to the WTO Agreement on Subsidies and Countervailing Measures (SCM Agreement), each member country is committed to notify the WTO when it adopts a domestic subsidy that can be trade-distorting. Today, information is available for less than half of the WTO membership. Transparency can encourage domestic decision-making to reflect national economic, more than special interest, considerations. And transparency might help to avoid a return to a 1980s-style situation, when rounds of subsidies, countervailing duties and other measures resulted in industrial deals that carved up global markets.

   The G20 could enhance the role and authoritativeness of the WTO by providing it with the necessary resources to work and issue timely public reports in this area. The WTO and the IMF should also be directed to share resources to facilitate rapid fact collection and analysis in the WTO surveillance of every WTO member nation, without exception.

3. ***Trade financing***: WTO Director-General Lamy has taken a positive step in this key area of concern by creating a global liquidity pool to cover the shortfall in financing; this will be a critical lubricant for world growth. The WTO is coordinating with the World Bank and the IMF, which are best suited to perform this function.
4. ***A grander, greener global bargain where trade rules apply to energy***: The G20 should send a proactive liberalizing signal to the world. The question is how. Should the G20 call for a revival of the Doha Development Round of multilateral talks? I have my doubts. The new US administration is hard pressed to manage its legacy from the previous administration. To try to revive the moribund talks after seven and a half years of negotiations may be fruitless and distract from other politically pressing priorities. The Doha Round has scant support in Congress, which holds the constitutional power to regulate foreign commerce. Leading US business and farm groups have called on President Obama to push advanced developing countries such as India and Brazil to offer 'balance and greater ambition' to these efforts, and have said that otherwise there is 'no basis for another ministerial meeting'.

    There are other ways to maintain and expand the benefits of trade. The G20 should link its action programme to the work of global leaders preparing for the UN's Copenhagen climate change summit in December 2009, to advance economic, trade and climate change goals. The G20 should breathe life into other WTO activities than sponsoring the Doha Round, including:

    a. Making a down payment on a greener, grander bargain by pledging to undertake WTO-sponsored plurilateral, sector-by-sector agreements to reduce trade barriers on clean energy goods and services. Such a sector-specific undertaking by G20 members might snowball into broader WTO commitment, just as a US–Japan bilateral in the 1990s formed the basis for the WTO's Information Technology Agreement.
    b. Empowering the WTO to monitor and publicize industrial and agricultural measures that are trade-distorting, impoverishing and environmentally degrading. The Director-General has recently expressed interest in undertaking greater surveillance in the future. The WTO surveillance function should be directed to look not only prospectively but also retrospectively into laws and regulations that G20 nations have accumulated when they are particularly egregious from the point of view of trade, poverty reduction and sustainability. If a nation thought that it might be subject to surveillance, that could tip a decision to alter its domestic policies. Examining the ethanol tariffs which are part of a broader US biofuels subsidy policy would make a strong impact, particularly on Brazil.
    c. Shining a light on the fact that WTO rules do not cover trade in energy, and recognizing that since energy is the lifeblood of the global economy, it should not remain outside the world trade system for another thirty years. The agriculture stalemate at Doha should be telling trade negotiators that this may be the moment to shift their efforts away from agriculture so that they have more time and resources to focus on energy. This could be a way to end the long WTO negotiating stalemate with India and other countries.

On 15 November 2008, members of the G20 'committed to the rule of law, respect for private property, open trade and investment, and competitive values'. Virtually every member of the G20 is a member of the WTO. They should pledge to initiate negotiations to apply the WTO rules to the energy sector. The members of the G20 which are also members of OPEC should play by the rules of the marketplace, with no exceptions.

The United States, China and other G20 members

The G20 membership of developed and developing nations reflects the shift in economic power in the world. For a variety of different reasons, some G20 members may not be willing to take tough decisions to be part of a collective action. In such a case, individual nations including the United States and China should be prepared to work opportunistically with those countries within the G20 that will act. The past multilateral trade rounds depended on the US working together with Canada, Europe and Japan: the Quad. The G20 is an experiment that still requires leadership and focus. The United States has traditionally played that role, often with important help and cooperation from key European friends. Is the US ready to play this role?

There are two hopeful political developments suggesting that President Obama is laying a good political basis to advance a positive trade agenda that is also consistent with his administration's climate change goals. One of the least noticed components of the American Recovery and Reinvestment Act of 2009 was the reform of the Trade Adjustment Assistance (TAA) programme, which expanded assistance to service-industry employees as well as workers in manufacturing. The passage of changes to the TAA had eluded Congress for the entire eight years of the Bush administration. The TAA reforms were three years in the making and are the result of significant bipartisan cooperation in the Congressional committees responsible for trade. The passage of TAA reform is a key domestic political precondition for any bipartisan trade-liberalizing initiative. In addition, President Obama's budget plan contemplates redirecting trade-distorting agricultural subsidies away from subsidizing production and towards conservation goals.

What role will China play? This contribution has not examined exchange rate policies, nor the destabilizing role played by trade deficits or trade surpluses, nor the traditional role played by the United States as the consumer of first and last resort for countries such as China that are pursuing export-driven growth strategies. China has been a great beneficiary of America's open market for imports, and has stunned the world by its rapid economic rise and influence. Will China now implement economic policies to demonstrate that it recognizes its critical national stake in maintaining the global trading system? China would seem to have national interests compatible with multilateralism and globalization. The great export superpower has the potential to be a great consumer, for example. Its initial $586 billion stimulus suggests it knows it needs to spend on domestic consumption, including providing health services to its people. It remains to be seen how much this can be linked into broader G20 efforts, but it certainly needs to be considered.

Moving Towards a Better-balanced Global Economy

Jim O'Neill

This contribution covers two broad areas of relevance: what are the critical issues the G20 did not address in November 2008 that are affecting the global economy, and what policy prescriptions address these challenges? The key issues considered include global imbalances, the monetary system and the exchange rate mechanism.

While we must all hope that we will never see another crisis of the dimension of today's, it is important to recognize that financial economical crises do, and will, occur, and whatever the G20 tries to adhere to, no policies can be devised that would altogether avoid some cyclicality for the world economy. The G20 meeting should therefore aim for realism. Indeed, one of the most critical goals that the November G20 mentioned – and which should be easily attainable – is the system of governance. This will be considered further below.

Other contributions to this report focus on the need for remedies to stop the world recession through appropriate monetary and fiscal policies, as well as by introducing better regulatory policies to govern the financial system. While the moves under way to stimulate economies through aggressive monetary and fiscal actions are to be welcomed, and the tone of coordination is pleasing, the reality is that monetary and fiscal policies are generally the domain of domestic economic policy. There is a limit to what the G20 can achieve. The same, to a degree, is also true of the regulatory framework for each of our major financial institutions. Depending on where it is located, the specific activity of the institution is likely to have a system of governance that best fits with the social policies and culture of the country in question. That said, and where commonality of interest can be shared, an enhanced framework of capital usage by banks and other financial institutions may be feasible. Guiding our financial systems to raise more capital in times of buoyancy, thereby helping to reduce the need for such measures in less buoyant times, would seem attractive to all. Similarly, policy-makers need to introduce a system of risk indicators and warning indicators so that, supplementary to the goals of low inflation, policies can be introduced to prevent the excesses that led to the current turmoil. Many of the proposals for the G20 made in the recent report by the Issing Committee[1] are to be welcomed here.

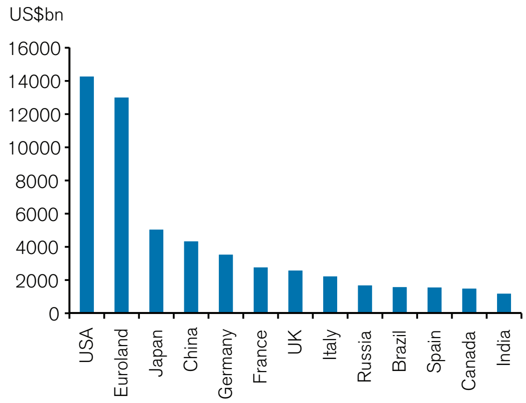
One small but important point linked to the committee's recommendations, especially with respect to the need for better 'risk warning indicators', is that there is also a clear, broader need for better economic data in many countries. For instance, if Korea can very usefully report its previous month's trade data on the first day of the following month, why cannot the US do this? Similarly, detailed data on consumer activity, which ironically some of the biggest commercial banks must have, could be reported more speedily.

Until the Cape Town G20 November 2007 meeting, and the Washington November 2008 meeting, the G7 and G8 remained the primary fora for international cooperation to deal with the world's challenges. In my judgment, neither the G7/G8 fora nor the G20 are optimal. A revamped G7, or one reduced to a G4, consisting of the appropriate economic policy representatives from China, Japan, the Eurozone and the US, is the most viable body to address the major challenges of foreign exchange misalignments and global imbalances. Ideally, a mechanism should also be agreed to avoid any stigma attaching to changes in the membership of the G4 over time as a result of changes in economic performance. It is conceivable that, just as

1. See *New Financial Order: Recommendations by the Issing Committee*, 2 February 2009, http://www.bundesregierung.de/Content/DE/__Anlagen/2009/02/2009-02-09-finanzexpertengruppe,property=publicationFile,property=publicationFile.pdf.

Canada and the UK should not be members today, perhaps Japan should not be in the future. Furthermore, it is conceivable that India, another so-called BRIC, or other as yet unidentified countries, might need to be at that table at some point in the future. Figure 1, showing the size of the major economies at the end of 2008, provides ample evidence to support the relevance of such a G4 today.

Figure 1: The world's largest economies, end-2008



Source: Goldman Sachs Global Economics Research

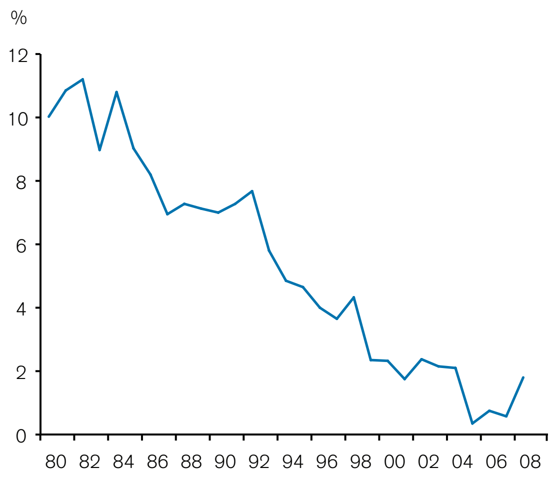
To supplement the G4, a G8 widened to a G13 by the inclusion of Brazil, China, India, Saudi Arabia and South Africa, as proposed by World Bank President Robert Zoellick, would also be necessary. Such an arrangement would help achieve an optimal world economy, including in critical policy areas such as energy usage, alternative energy and environmental issues, as well as addressing free trade issues and world poverty. I sincerely believe that a G4 supplemented by a G13 would help navigate the kind of challenges the world has faced this decade and indeed could have been better prepared for.

In reality, of course, not just the host for the G20 (the UK) but many of those 'excluded' would not agree to these quite simple changes. But without them, I fear that other substantive steps cannot be achieved. The G7/G8 policy is clearly not representative and, in any case, the EMU participants, France, Germany and Italy, all adhere to the same currency and are, in a general sense, governed by the same fiscal framework. Even more importantly, although many policy leaders willingly assert the need for reform of the IMF and World Bank, a better ownership structure – and purpose – for the IMF will probably not be achievable unless the EU countries, and especially the EMU participants, agree to be represented jointly. Perhaps the G20 remains the most practical forum in the near term, but without a dismantling of the G7/G8, a sensible reform of the IMF cannot be achieved.

Linking this specifically to what the November G20 meeting failed to focus on, I believe, as do many others, that much of today's crisis was caused by the build-up of global imbalances, both in terms of the external balance of payments (especially in the US and China) and the closely related domestic savings–investment imbalances. Throughout this decade, many of us identified a number of variables that might lead to considerable problems, including the large rise in the US balance-of-payments current account deficit to close to 7 per cent of GDP at its peak; the related deterioration in the broad (my definition, including net portfolio and FDI flows) basic deficit in US balance of payments to 2–3 per cent of GDP; the decline in the US personal savings rate to zero; the large increase China's current account surplus to 8–9 per cent of GDP; and the persistence of a Chinese savings rate in the vicinity of 40 per cent of GDP. Germany and Japan, among other countries, have played their own role in the build-up to these global imbalances. The general broad (again my definition) surpluses of China, India, Brazil and other large emerging-market countries are another related aspect of the imbalance problem. Seen in this light, many of the prescriptions in the November 2008 G20 statement would not deal with the underlying causes. The clearly massive problems that have emerged from the regulatory shortfalls can perhaps be regarded as symptoms rather than causes. They do, of course, need to be addressed urgently, and, as mentioned above, the recommendations outlined by the Issing Committee are sensible; nevertheless, the underlying causes need more thought and, perhaps, more attention.

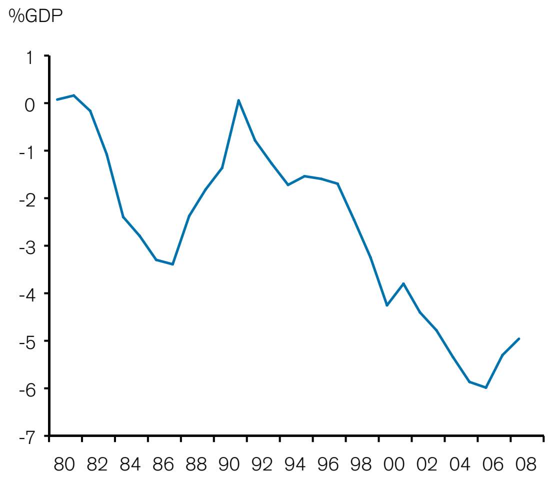
In this context, the thrust of policies in the different G20 countries needs careful consideration. Monetary and fiscal policies in the US need to maintain the rise in the personal savings rate that has occurred, while such policies in the largest savings countries, such as Germany, Japan and especially China, need to encourage private-sector demand. If further thought is not given to these differen-

Figure 2: US personal savings rate, 1980–2008



Source: Bureau of Economic Analysis

Figure 3: US current account balance, 1980–2008



Source: Bureau of Economic Analysis

tial policies, little will be achieved in terms of addressing underlying imbalances.

In fact, it should be recognized that there are some good signs on the US side of the equation. As Figure 2 shows, the personal savings rate has started to rise, and Figure 3 shows that the external current account deficit has started to decline as a share of GDP.

In a recent paper,[2] I showed that in any of three scenarios – 'bad', 'better' or 'best' – the US current account deficit will decline further (see Table 1).

What is less clear is whether similar evidence exists in other countries. Moreover, the 'desired' scenario for US current account improvement is the 'best' one. This is, in reality, what the US would and should like, and it would be consistent with a better world economy. If the US current account deficit stayed on the 'best' path – namely, around 3 per cent of GDP, with strong real export growth and 'softish' import growth – this would mostly likely occur in an environment where global domestic demand expansion was led from outside the US. In that regard, and pertinent to the G20 meeting, the expansive fiscal – and monetary – measures adopted in China, Germany and Japan should be welcomed. However, further thought needs to be given as to the effectiveness of these measures in stimulating their rates of domestic consumption. For example, do the Chinese authorities have a strong view on what causes their very high rate of domestic savings? Since their own measure to stimulate growth, announced late in 2008, a lot has been heard about plans to introduce state medical insurance to 90 per cent of all rural citizens by 2011. Has

Table 1: US trade outcomes – three scenarios

	Bad scenario		Better scenario		Best scenario	
	Exports	Imports	Exports	Imports	Exports	Imports
	-8.4%	-14.7%	+12.0%	+7.4%	+11.8%	-0.12%
Monthly trade deficit (US $bn)	-25.7		-36.8		-24.5	
% of GDP	-2.2		-3.1		-2.1	

Source: US Census Bureau, Goldman Sachs Global ECS Research

2. Jim O'Neill, *The Outlook for the Dollar in the Next Decade*, Goldman Sachs Global Economics Paper No. 180, 17 February 2009, https://360.gs.com.

research been published on the macro consequences of these policies? Are they likely to reduce the savings rate? More broadly, these are the kinds of questions that the major savings countries need to be asking themselves, and sharing with the IMF and G20. They are especially pertinent now that more evidence is available about Q4 2008 GDP growth – or the lack of it. Within the widespread weakness, it is striking that both Germany and Japan (along with a number of other Asian exporting countries) saw their GDP decline more than the US, despite the fact that they are supposedly not suffering from the same excesses. Clearly, they are highly vulnerable to external weakness. Policies need to be introduced that not only shift this dependency but somehow contribute so much to domestic demand that there is a significant impact on the import growth of those countries. Of course, these issues bring us back full circle to the questions raised about what the G20 can or cannot realistically expect to achieve collectively.

There is one other area where I believe the G20 could reasonably have a genuine chance for coordination, and this is with respect to policies to address climate change and encourage alternative energy use, and the case for further procyclical fiscal policy expansion. Many of the G20 leaders – especially given the change of administration in the US – appear to broadly share a goal of reducing CO_2 emissions in the atmosphere; how much will become apparent by the time of the Copenhagen Summit in December 2009. If they are eager to demonstrate their commitment to lead the world's population down the path of improved energy efficiency and seek alternative energy sources, plans could be coordinated through this channel, for instance through some kind of coordinated taxation policy to raise fuel taxes on large vehicles, together with subsidies or even 'gifts' to enhance home insulation, and other measures. Although it would be difficult for the G20 to agree a plan of action by 2 April, an announcement of such plans, along with proposals for reformed international governance, might be the best demonstration that our leaders are using this current grave crisis to adapt to the challenges of the future, as well as those of today.

Regionalism and Monetary Consolidation

Paola Subacchi

Global imbalances and the eruption of the global financial crisis have shown the limits of financial globalization and the tension between domestic agendas and global issues. Like trade, the exchange rate is at once cause and effect of such tension. Much political activity has been directly or indirectly shifted towards the exchange rate in ways that imply new economic and political divisions. Fixing the exchange rate in a world of mobile capital implies forgoing national monetary policy autonomy in favour of greater certainty about the value of the currency. And this raises problems of international policy cooperation.

A new monetary order is required that would require currency consolidation in three main regional blocs, each using a particular currency and featuring a high level of intra-trade. Two of these blocs are already in place: a *de facto* dollar area in the Americas and a single currency union in Europe. The missing one is Asia, where economic integration has been deepening steadily in recent years through the market-driven forces of cross-border trade, foreign direct investment and finance. The G20 should provide a forum for debate relative to the international monetary order while a sub-group limited to the main currency areas would monitor exchange rate arrangements and decide on changes in these arrangements.

A patchy picture

The world economy remains characterized by diverse, uncoordinated exchange rate arrangements, even if stronger economic integration in the last twenty years has resulted in some monetary consolidation, especially following the creation of the single currency union in Europe. In the ten years since its launch the euro has become the second international currency, after the US dollar.

Greater openness to the rest of the world, with a shift from inward-looking import substitution and public-sector investment to outward-looking export promotion and private-sector investment, and growing regional inter-dependence have turned Asia into a key region in the world economy – this is evident even in the current crisis. Partly as a consequence of the crisis of 1997, however, the region presents broad diversity in exchange rate regimes, with no exchange rate policy coordination in place. The two dominant countries, Japan and China, diverge widely in terms of exchange rate regimes, the former being close to a pure float, the latter having a heavily managed, crawling peg regime linked to the US dollar. All other Asian economies adopt intermediate regimes of managed floating with the US dollar as the most important anchor currency. They adjust their dollar exchange rates in line with changes in the bilateral exchange rates of currencies in their baskets, in order to maintain stability in their nominal or real effective exchange rates.

The US dollar plays an important role in Asia both as an anchor currency and – as its very high weight in foreign exchange market trading suggests – as a vehicle currency, mediating exchanges of various currencies. For example, conversion of the Japanese yen into the Korean won is done typically through the US dollar: first the yen is converted to the dollar and then the dollar is converted to the won. This mediating role is usually explained by the low transaction cost, owing to economies of scale and the 'public good' nature of the dollar: people prefer to use dollars because almost everyone else uses them too.

Why exchange rate coordination?

Given Asia's focus on external trade, it makes sense to stabilize the exchange rate *vis-à-vis* the currencies of its main trading partners – the dollar first, and the euro next. Regional interdependence, however, has increased in recent years, in particular in East Asia, where intra-regional trade has been growing. This deepening regional economic integration and the rising business cycle synchronization suggest that in order to maintain intra-regional exchange rate stability, policy coordination would be more appropriate than the traditional policy of pegs to an external anchor, while regional monetary cooperation is apt to intensify as regional integration deepens.

The absence of a common policy framework in Asia means that countries tend to pursue their own domestic objectives regardless of the possible adverse impact on neighbouring economies. Within such a system there is a built-in incentive for each country to err on the side of currency depreciation so as to gain and maintain competitiveness *vis-à-vis* its neighbours. A regional framework for exchange rate regime coordination needs therefore to be developed in order to reduce spillovers and avoid 'beggar-thy-neighbour' types of problems.

How can such coordination be achieved in the region? Exchange rate policy cooperation is not easy. It normally implies several levels of collaboration, from a minimum of information-sharing to the maximum represented by common monetary policy; the provision of mutual support, normally in the form of lending facilities, and a common anchor are intermediate levels.

In the case of Asia, monetary policy coordination requires a gradual, three-step approach complemented by stronger cooperation in the areas of finance and trade. The first step would be for the regional economies to discuss exchange rate issues as part of enhanced economic surveillance. This would imply the development of an index to measure volatility of exchange rates, as well rationalizing policies on the exchange rate and capital account.

The second step would be for those economies to coordinate informally on exchange rate regimes by moving towards greater exchange rate flexibility *vis-à-vis* the US dollar, and then gradually towards the same exchange rate regime. Given the different levels of development among countries in Asia, the most suitable initial regime is the adoption of a managed float, which would offer the additional advantage of moving China to a more flexible regime.[1] This level of policy coordination should be relatively easy to achieve and manage.

The third step would be to secure a credible regional monetary anchor through a combination of some form of national inflation targeting and a currency basket system. Since the Japanese yen has only a limited degree of internationalization, and the Chinese yuan lacks full convertibility, the challenge here is to find a suitable currency basket, particularly for regional currencies.[2]

Choosing the US dollar as the region's sole monetary anchor is no longer the best policy. East Asia now has strong economic ties with the world's major economies and regions, so that dollar-pegs can be too restrictive. Research shows that in GDP terms the area covered by the US dollar has declined from 53 per cent of the world economy in the early 1970s to about 45 per cent in 2005–07.[3]

Choosing either the yen or the yuan, or both, as a monetary anchor on the basis of the size and importance of Japan and China would be an obvious choice. However, it would not be advisable, given Japan's relative economic decline and the yuan's limited international role – although a peg to the yuan would be desirable from a trade perspective. Other East Asian economies, however robust their monetary policies, are too small for their currencies to take on a meaningful international role. This clearly makes it desirable to introduce a mechanism for intraregional exchange rate stability based on a currency basket, as no single currency is capable of playing a monetary anchor role, at least in the near future.

As Japan would maintain its current free float, the other economies in East Asia, including China, should adopt, at least as the first step, a basket system based on the three main currencies – dollar, euro and yen. By so doing, they could enjoy more stable effective exchange rates, with less susceptibility to dollar–yen and dollar–euro fluctuations than a standard US dollar-based system. Korea and Thailand, in recent years and without any formal commitment, appear to have already adopted a similar regime.

1. China's yuan revaluation in July 2005 and its shift to a managed crawling peg is already a step in the right direction.
2. There would be another step towards full coordination, which would imply the creation of a regional system similar to the Exchange Rate Mechanism (ERM) in Europe. However, given the lack of economic convergence and political agreement, this is not a feasible option.
3. Masahiro Kawai, 'Toward a Regional Exchange Rate Regime in East Asia', *Pacific Economic Review* 13 (1) (2008), pp. 83–103.

This system could then be replaced with a basket in which a weighted sub-basket of regional currencies, including the yen, yuan, won, etc., is substituted for the yen.

The solution: exchange rate cooperation?

Exchange rate policy coordination is a gradual process that can be strengthened within the existing policy dialogue among the region's finance ministers (such as ASEAN+3) and central bank governors (such as EMEAP, the Executives' Meeting of East Asia-Pacific Central Banks). Greater political support for economic policy coordination could even eventually lead to further institutional integration capable of supporting intraregional exchange rate stability. Indeed, Asia as a whole may not be an optimum currency area, but several sub-groups of the region's economies may form currency areas.[4] For this to happen, substantial convergence will have to be achieved across countries in the region in terms of economic, financial and structural conditions, performance and policies.

Even if regional institutions do become pivotal, there is a role for the G20 policy dialogue, as exchange rate regimes are not a matter solely for countries in the region. The accumulation of reserves by Asian countries is already causing controversy at the international level and raises the issue of both the relevance and the governance of the IMF. Moreover, the dollar may weaken as a result of the current crisis and the rapid slowdown of the US economy, putting upward pressure on the other main currencies and pegged currencies. This process may be destabilizing unless accompanied by closer policy coordination and more intensive exchange rate management.

Failure to incorporate the exchange rate policy dialogue within the G20 process may result in Asia drifting towards inward-looking regionalism. A great deal of regional financial cooperation is already in place through the Chiang Mai Initiative – a network of credit arrangements connecting the East Asian countries – the Economic Review and Policy Dialogue, and the Asian Bond Markets Initiative. Strengthening these initiatives through further enlargement and a reduction in the link to the IMF could set Asia apart in the international economic dialogue. It is therefore critical to provide a window within the current process to discuss Asia's policy options. At the same time, greater collaboration and harmonization needs to be encouraged between the region's finance ministers and central bank governors as well as among the region's financial supervisors and capital market regulators.

4. See Shingo Watanabe and Masanobu Ogura , 'How Far Apart Are Two ACUs from Each Other?: Asian Currency Unit and Asian Currency Union', Bank of Japan Working Paper Series No. 06-E-20, November 2006.

Let the Exchange Rates Find Their New Equilibrium

Stephen L. Jen

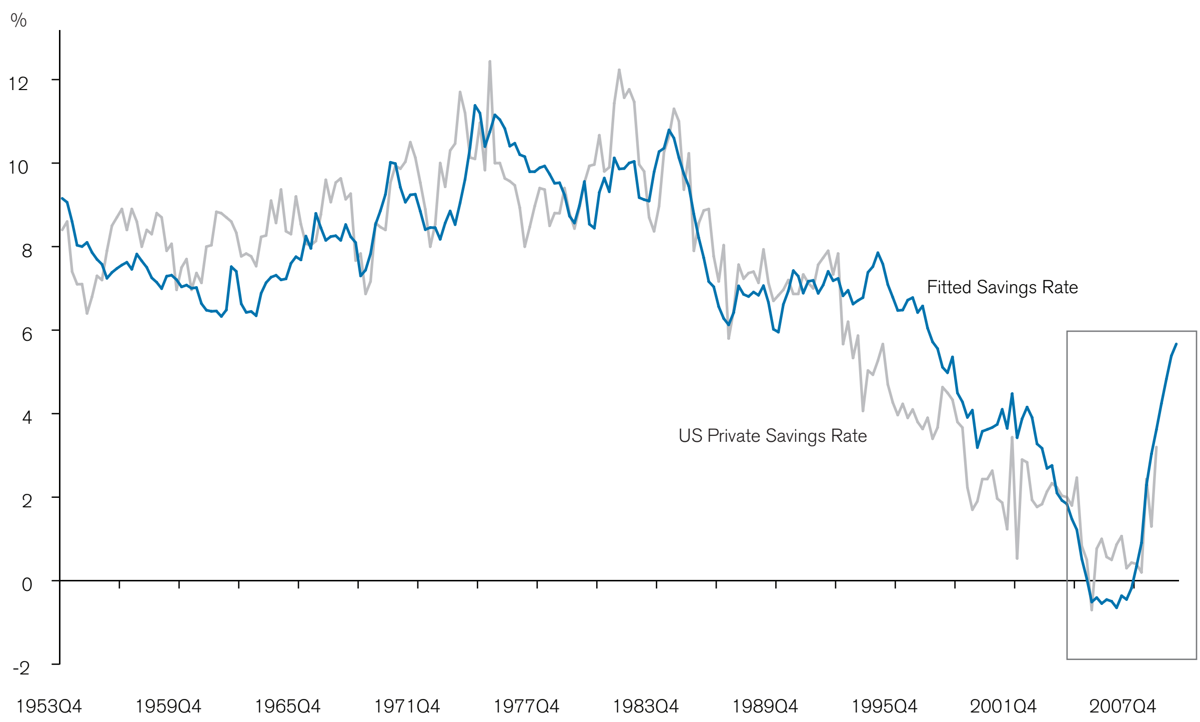
There are some issues that the G20 needs to address, but in my view exchange rates are not one of them. A significant structural realignment in the world's external imbalances is unfolding, and currency flexibility should be permitted to allow exchange rates to find their new equilibrium levels.

A significant compression in the US current account deficit is likely in the coming years

The immediate and medium-term outlook for the global economy remains unclear. However, a sharp compression in the US current account deficit is likely to be one of the most important trends in the coming years, with obvious implications for the rest of the world. During the past cycle, the US ran very large current account deficits (US$7 trillion in 2008 dollars, which coincidentally is similar to the total size of foreign reserves in the world). These are not likely to be repeated in the years ahead. The declining (since 1985) and low (especially during 2004–08) private savings rate in the US was mostly a function of the bloated housing and equity wealth, and not a reflection of irrational behaviour by US consumers. Now that this wealth has been eroded, the rate is likely to rise from roughly zero in recent years to 5.7 per cent by end-2009.

Figure 1 shows the actual US private savings rate. Further expected declines in housing and equity wealth suggest that the US private savings rate will continue to

Figure 1: US private savings rate, 1953–2008



rise, potentially to the 8–10 per cent range that prevailed up to the mid-1980s. This should, in turn, facilitate a compression in the US current account deficit that will only partially be offset by public dis-savings.

As a footnote to this discussion, the popular argument of the last few years that the US dollar should be used as a tool to normalize global imbalances may have been misplaced. Recent developments suggest that the underlying causes of, and therefore the cure for, global imbalances are more closely related to factors that contributed to the housing and equity bubbles than to misaligned exchange rates. Fixation on exchange rates, rather than financial and regulatory policies that mattered for asset prices, may have misled policy-makers.

Narrower savings deficit will pose a challenge to many emerging-market economies

While it is important to ask how long and how deep the current recession will be, perhaps an even more important question is what the *configuration* of the global economy will be in the 'new' world. Specifically, what will be the growth trends for the previously export-dependent economies (including those in Asia and Latin America), which had been buoyed by the unsustainable US current account deficits? Will their potential growth rates be lower than in the past years? To the extent that global demand for oil had been artificially boosted by these US deficits, indirectly raising the world's demand for energy products, oil-exporting countries will also be adversely affected by this coming structural compression.

Fair values of EM currencies changed?

Fair value (FV) calculations are regression-based. If the world has indeed changed, FVs based on historical and traditional variables are no longer valid. Further, these models usually only include real variables and not the 'balance sheet' variables that are so important now. In response to the structural balance-of-payments shift, if authorities in countries worldwide no longer know where the FV or the equilibrium values of their currencies will be, they will have difficulty in justifying heavy level-defending interventions. If anything, there is now an incentive for those in authority to let exchange rates find their new equilibrium. This point also applies to emerging-market countries with hard pegs: when the fundamental FVs change, pressures on these pegs could reflect genuine gapping down of the shadow FVs, rather than speculation.

Issues for the G20

1. ***Domestic demand in Asia***. The benefits of Asia's adopting a development strategy centred on domestic demand are clear, but it is less clear how this objective can be achieved. There are a number of reasons why China's private-sector savings rate is so high, apart from a cultural proclivity to save. Redesigning a viable social safety net that will be appropriate for the demographic trends in China will take time. The G20 is an appropriate forum for a clarification by the capital surplus nations on how they plan to stimulate domestic demand to offset the rise in savings in the US.
2. ***A more modest goal for the G20***. There have been a number of proposals in the media that may not be deliverable. What are the realistic objectives of the G20 in the current environment? The G20 should exercise care to manage and not to inflate investors' expectations. It should be seen, first, as the preferred forum to enhance communications among the members, just as much as a platform for coordinated actions. Second, it may be difficult for the G20 to agree on collective action: if the G7 could not reach an agreement on concrete coordinated policies, what can be expected of the G20? In turn, the G7's actions are limited by the difficulties experienced by the members of the EU/EMU in reaching an agreement on important issues. Third, as general deleveraging continues, investors are likely to ask whether the world can remain 'multi-polar' and to find the answer far from clear. What we have learned so far in this crisis is that the world is coupled to and reliant on the US. Unless the US financial markets and economy stabilize, it is difficult to see the rest of the world

stabilizing. Are we, then, in a way, not moving back to a 'G1'-dominated world?

3. ***Eastern Europe–Eurozone the next flashpoint?*** The Eastern Europe–EMU/EU nexus is a serious and inadequately addressed issue. In contrast to much of the rest of the world, Eastern Europe has a typical balance-of-payments crisis. How Western Europe deals with this crisis will have implications for the Eurozone and the euro itself. Important structural ambiguities in the EMU that were intentionally put in place to enhance fiscal prudence in the member countries now need to be clarified. In general, there are acute trade-offs between the measures that may need to be deployed to deal with complications related to the balance-of-payments crisis in Eastern Europe and the long-run implications of such measures for the Eurozone.

4. ***Fix versus flex – the long-standing debate on the preferred currency regime***. The G20 should exercise care not to impose too much rigidity on exchange rates. While exchange rate *volatility* may at times become excessive, and interventions may be needed, currency *flexibility* is desirable as the long-term economic fundamentals experience significant changes. Further, the international community needs to have a consistent stance on how it confronts countries' choices of exchange rate regimes. On the one hand, fixed exchange rate regimes are seemingly celebrated in Europe (e.g. in Latvia or Spain), regardless of whether the parities are consistent with the external balances. On the other hand, they appear to be criticized when Asian countries try to peg to the dollar.

Appendix: Workshop Agendas

New Options for the G20 Leaders: US Working Group
Chatham House–Atlantic Council Working Group

08.30–17.30, Monday, 2 March 2009

Agenda

08.30–08.45	**Introduction and Opening Remarks**	
		Frederick Kempe, The Atlantic Council of the United States
		Robin Niblett, Chatham House
08.45–09.30	**Challenges and Priorities for the G20: Framing the Discussion**	
	Speaker:	Stuart Eizenstat, Covington & Burling
9.30–11.00	**Panel 1a: Guidance to G20 Working Groups: Session I**	
	Panelists will review issues relating to G20 Working Group I: 'Enhancing Sound Regulation and Strengthening Transparency' and/or Group II: 'Reinforcing International Cooperation and Promoting Integrity in Financial Markets'	
	Chair:	Robert Rosenkranz, Delphi Financial
	Panel Members:	Rita Bolger, Standard & Poor's
		Robert Hormats, Goldman Sachs
		Robert Nichols, Financial Services Forum
11.00–11.15	**Coffee Break**	
11.15–12.15	**Panel 1b: Guidance to G20 Working Groups: Session II**	
	Panelists will review global economic governance and those issues relating to G20 Working Group III: 'Reforming the IMF / International Financial Institutions' and/or Group IV: 'The World Bank and other Multilateral Development Banks'	
	Chair:	Brian Henderson, formerly of Merrill Lynch & Co.
	Panel Members:	Ralph Bryant, Brookings Institution
		Alex Gibbs, IMF
		Domenico Lombardi, Oxford Institute of Economic Policy
		Susan Schadler, Head of Evaluation, IMF's Role in Trade Policy
12.15–13.15	**Lunch: Keynote Address: Global Reality and the Financial Outlook**	
	Speaker:	Christian Menegatti, RGE Monitor
13.15–15.15	**Panel 2: The New G20 Agenda — Emerging Issues for April 2nd**	

As the crisis has continued to unfold in the months since the November Summit, certain macroeconomic and financial issues not addressed by the G20 November meeting now appear at the top of the agenda with respect to both national and broader G20 efforts:

- *Increasing protectionism (both trade and financial protectionism)*
- *Global imbalances, trade finance, and the role of additional fiscal stimulus*
- *Pricing toxic assets in national and international frameworks*
- *China's role in the new financial architecture*

Chair: Matt Slaughter, Dartmouth University Tuck School of Business

Panel Members: Uri Dadush, Carnegie Endowment for International Peace
Jim Rollo, Chatham House
Paula Stern, The Stern Group
Paola Subacchi, Chatham House

15.15–16.15 **Panel 3: Looking Around the Curve**

The final panel anticipates the critical macroeconomic and financial issues that can be expected to materialize in the next six to twelve months:

- *Devising government exit strategies for the current series of interventions*
- *Assessing global inflation risks*
- *Forecasting the role of official reserves in future public spending*
- *Appraising G20 prospects for success*

Chair: Adam Posen, Peterson Institute for International Economics

Panel Members: Alexander Mirtchev, Krull Corporation
Daniel Price, Sidley Austin
Douglas Rediker, New America Foundation

16.15–16.30 **Closing remarks**

16.30–17.30 **Reception**

Top of the Agenda: Critical Issues for the G20 Summit
Chatham House–Atlantic Council Working Group

08.30–17.00, Thursday 5 March

Agenda

Held under the Chatham House Rule[1]

08.30–08.40 **Welcome Coffee and Registration**

08.40–08.45 **Introduction and Opening Remarks**

Paola Subacchi, Research Director, International Economics, Chatham House
Alexei Monsarrat, Director, Global Business and Economics Program, Atlantic Council

08.45–09.30 **Keynote Remarks: Current Government Perspectives on the Approach to the Financial Crisis**

Chair: Paola Subacchi, Research Director, International Economics, Chatham House

Speaker: Stephen Pickford, Deputy Finance Minister, UK G20 Delegation; Managing Director, International and Finance, HM Treasury

1. 'When a meeting, or part thereof, is held under the Chatham House Rule, participants are free to use the information received, but neither the identity nor the affiliation of the speaker(s), nor that of any other participant, may be revealed.'

- *Briefing from Cabinet Office/ HMT on the current plans and expectations for the G20 meeting.*
- *Provide business leaders an opportunity to add perspectives on the real economy and set the stage for the day's discussions about the challenges the global financial system currently faces.*
- *Frame the questions that participants believe the UK, Europe, and the G20 governments should be asking themselves.*

09.30–11.00 **Panel 1a: Spotlight on the G20 working groups: coordinating rules and standards – levelling the global financial playing field**

Chair: Gay Huey Evans, Vice-Chairman, Barclays Capital

Speakers: Lord Eatwell, Director, Centre for Financial Analysis and Policy, Judge Business School
Barbara Ridpath, CEO, International Centre for Financial Regulation
Nicolas Véron, Research Fellow, Bruegel

- *Assess and propose recommendations on the G20's commitments to address the first two working group strands: (1) Enhancing Sound Regulation and Strengthening Transparency, and (2) Reinforcing International Cooperation and Promoting Integrity in Financial Markets*

11.00–11.15 **Coffee Break**

11.15–12.45 **Panel 1b: Spotlight on the G20 working groups: a new impetus for IMF and FSF reform**

Chair: Stewart Fleming, London School of Economics

Speakers: Andrew Baker, Senior Lecturer in Political Economy, Queen's University, Belfast
Lauren Phillips, Lecturer, Department of International Relations, LSE
Max Watson, Associate Fellow, Chatham House
Jonathan Portes, Senior Adviser, Economic Policy Issues, Cabinet Office

- *Assess and propose recommendations on the G20's commitments to address the issue of the reform of the IMF and FSF.*

12.45–13.30 **Lunch**

13.30–15.00 **Panel 2a: Widening the G20 agenda – Enlarging the G1 monetary system**

Chair: Philip Coggan, Capital Markets Editor, The Economist

Speakers: Jim O'Neill, Head, Global Economic Research, Goldman Sachs
Stephen Jen, Managing Director and Chief Currency Economist, Morgan Stanley
Paola Subacchi, Research Director, International Economics, Chatham House

- *What are the critical issues the G20 did not address in November that are affecting the global economy?*
- *What are the policy prescriptions to address these challenges?*
- *Key issues include: global imbalances, monetary system, exchange rate mechanisms.*

15.00–15.15 **Coffee Break**

15.15–16.45 **Panel 2b: Widening the G20 agenda – avoiding a resurgence of protectionism amid domestic crisis**

Chair: Richard Higgott, Pro-Vice Chancellor for Research, Professor of International Political Economy, University of Warwick

Speakers: Jeffries Briginshaw, Executive Director, TransAtlantic Business Dialogue
Fredrik Erixon, Director of the European Centre for International Political Economy
Gary Campkin, Head, International Group, Confederation of British Industry

- *What are the critical issues the G20 did not address in November that are affecting the global economy?*
- *What are the policy prescriptions to address these challenges?*
- *Key issues include: increasing trade and financial protectionism (e.g. 'Buy America' and 'Buy France' provisions and restrictions on visas).*

16.45–17.00 **Concluding remarks**

Robin Niblett, Director, Chatham House

Kindly supported by

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