

G20

APRIL 2009

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Christine Lagarde • Peter Mandelson
Trevor Manuel • Kamalesh Sharma
Andrew F Cooper • Donald Kaberuka
Paul Martin • John Kirton

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A global new deal

Gordon Brown

**Is recovery
on the horizon?**

Robert Fauver



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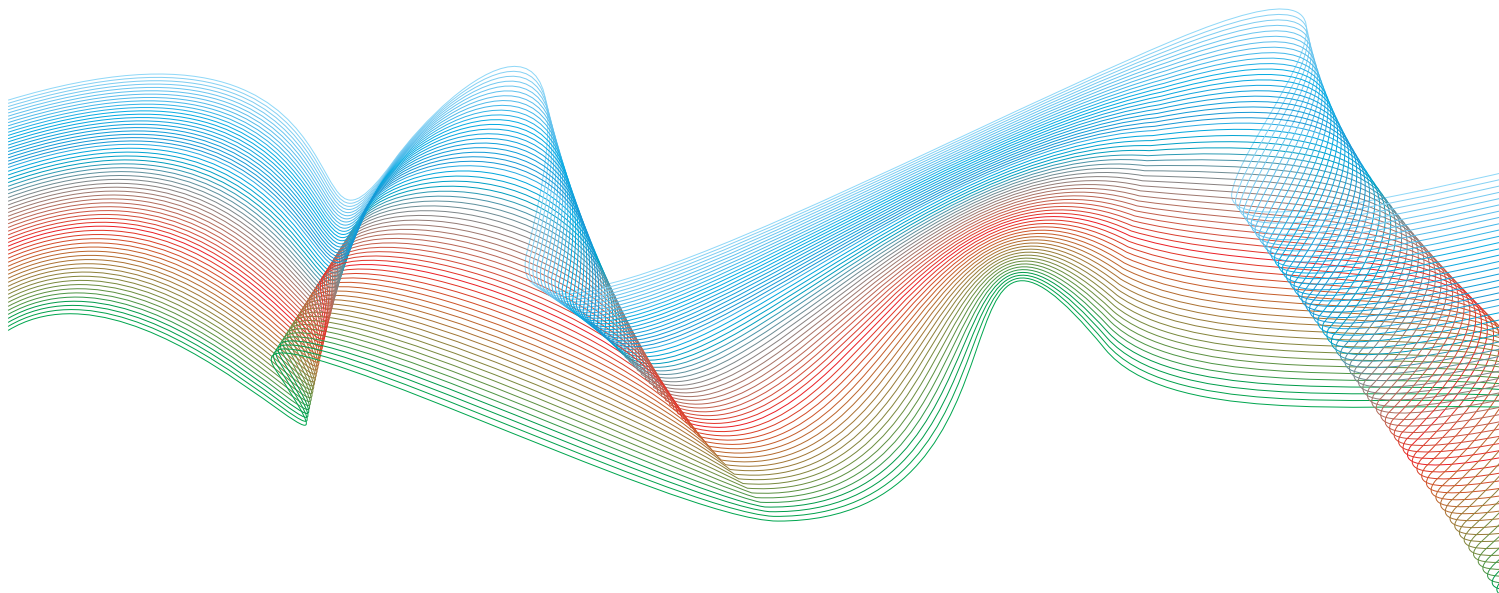
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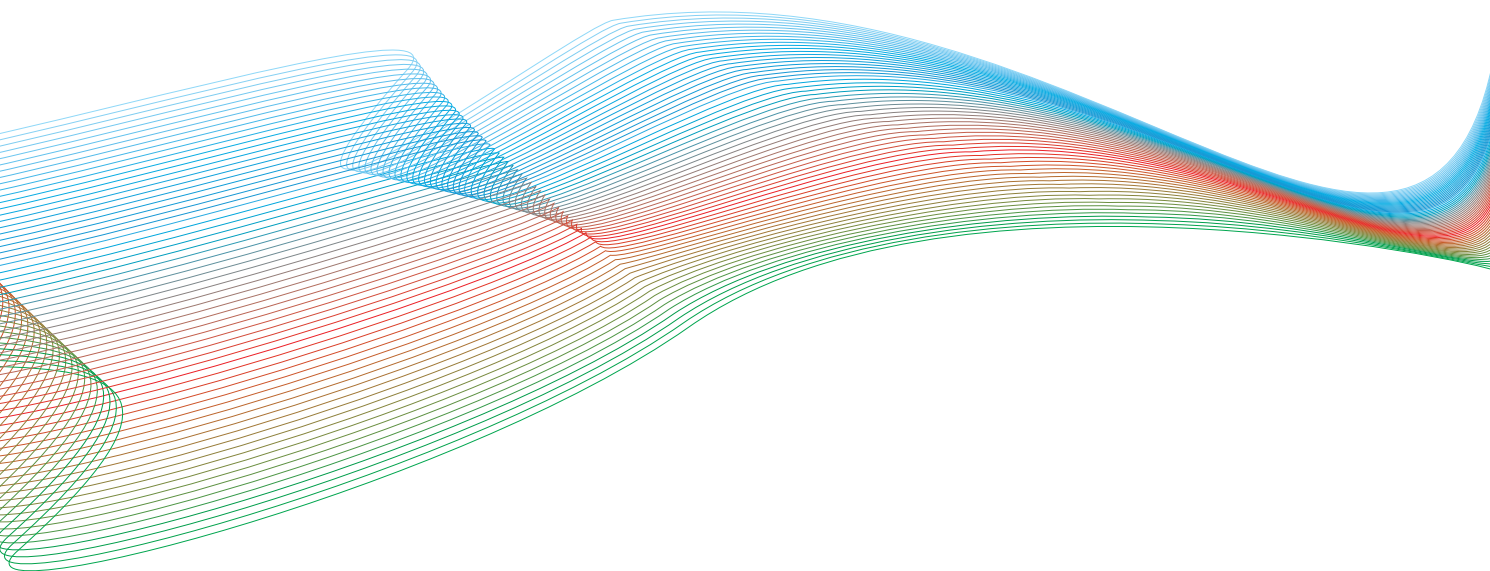
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A close-up photograph of a tiger lying in a forest. The tiger is looking directly at the camera with a calm expression. Its orange fur with black stripes is clearly visible. The background is filled with green leaves and branches, creating a natural, slightly blurred setting.

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G20

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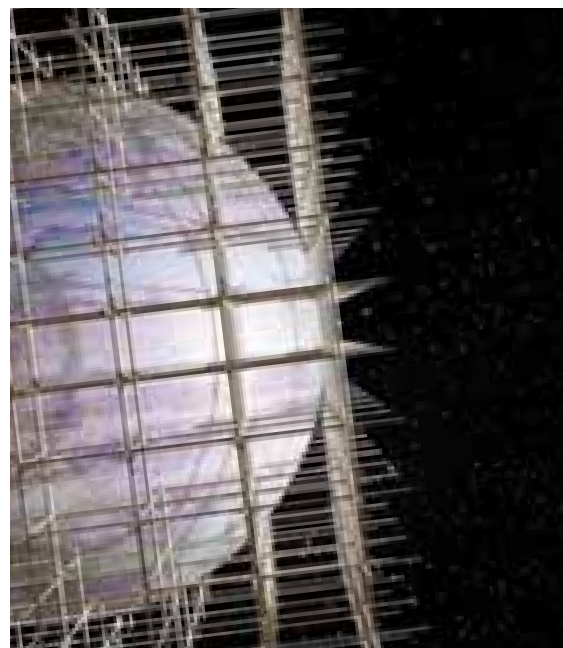
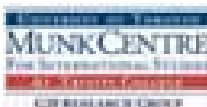
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Global economic growth and balance

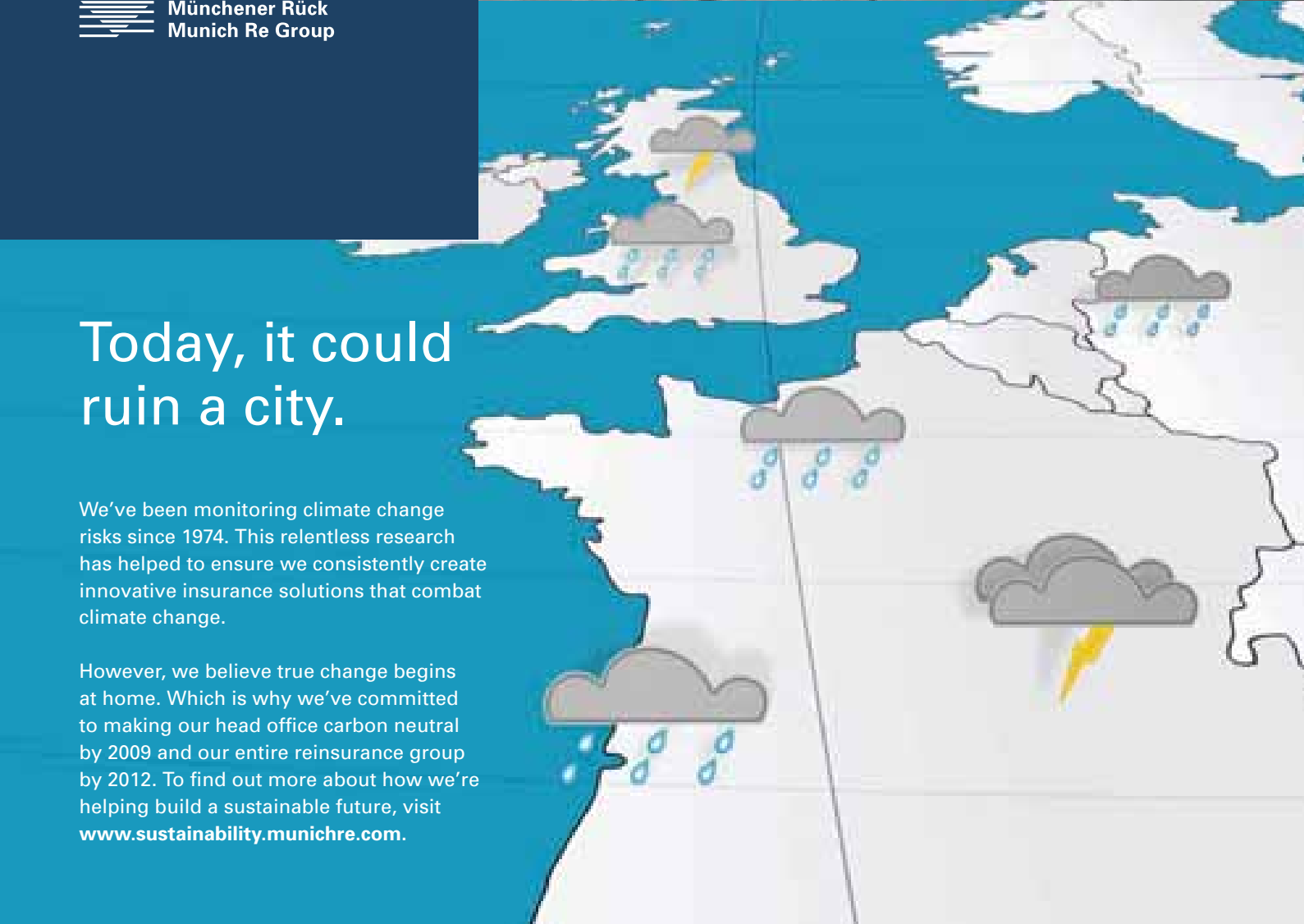
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Robert Fauver, former US under secretary
of state for economic affairs and former
G7 sherpa



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Welcome

UK prime minister Gordon Brown, host of the London Summit, sets out his hopes for a global new deal – an era of partnership, responsibility and sustainable recovery



Historians, when they look back on these months, will say this was no ordinary time, but a defining moment in our history: one of unprecedented global change, when one chapter ended and another began.

Globalisation has brought us great advances, as the benefits of economic growth and trade have lifted millions out of poverty. But globalisation has brought new insecurities too, as this – the first truly global financial crisis – has already shown. And today the whole world faces a new set of challenges: challenges that cannot be met by turning inwards to a protectionism that history tells us in the end protects no-one – but rather by reaching out to forge a partnership of purpose that must involve the whole world.

We do not yet have all the answers, but we know what is needed now: forward-thinking debate, robust analysis, visionary leadership, all with a common commitment to a better future.

So on the eve of the G20 London Summit, I very much welcome this collection of essays because together they cover so many of the critical issues world leaders will be addressing, including:

- how we maintain national interests without a retreat into protectionism;

- how we establish global accountability to match the ever more global flow of finance;
- how we enforce tighter regulation without stifling creativity and growth;
- how we harness the power of globalisation to strengthen Africa's role in the world economy;
- and how, amid the pressure to restore stability, we use the opportunities raised by this crisis to create a more just and more sustainable global economy.

The writers who explore these questions in this volume – from Trevor Manuel to Christine Lagarde, Haruhiko Kuroda to Peter Mandelson – are diverse in their perspectives, but they are united in their call to all of us to work together and to grasp this moment with courage, and in a spirit of co-operation.

This week, leaders from the world's biggest countries, representing over two-thirds of the world's population meet in London to agree action to see us through the current crisis. The London Summit will be a vital step in global efforts to restore stability, stimulate growth, create jobs, and invest in our shared future. I believe it is our chance to put in place the foundations of what I call a global new deal.

Such a global new deal will prepare the ground not just for a sustainable economic recovery but for a genuinely new era of international partnership – one in which all countries have a part to play. Such a partnership should ensure that in every continent



“ These are times of opportunity, so leaders must work together in common cause ”

each national economy gains from the injection of more resources, that all of us gain from a green recovery, and that no country shies away from its development responsibilities. And under a new global agreement, every country participating in the international financial system will agree common principles for internationally co-ordinated financial regulation, together with changes to national

banking systems that will bring us shared prosperity once again. Such an agreement would also bring reform of the mandates and governance of global institutions to match vast changes in the world economy, including the emergence of new players within it.

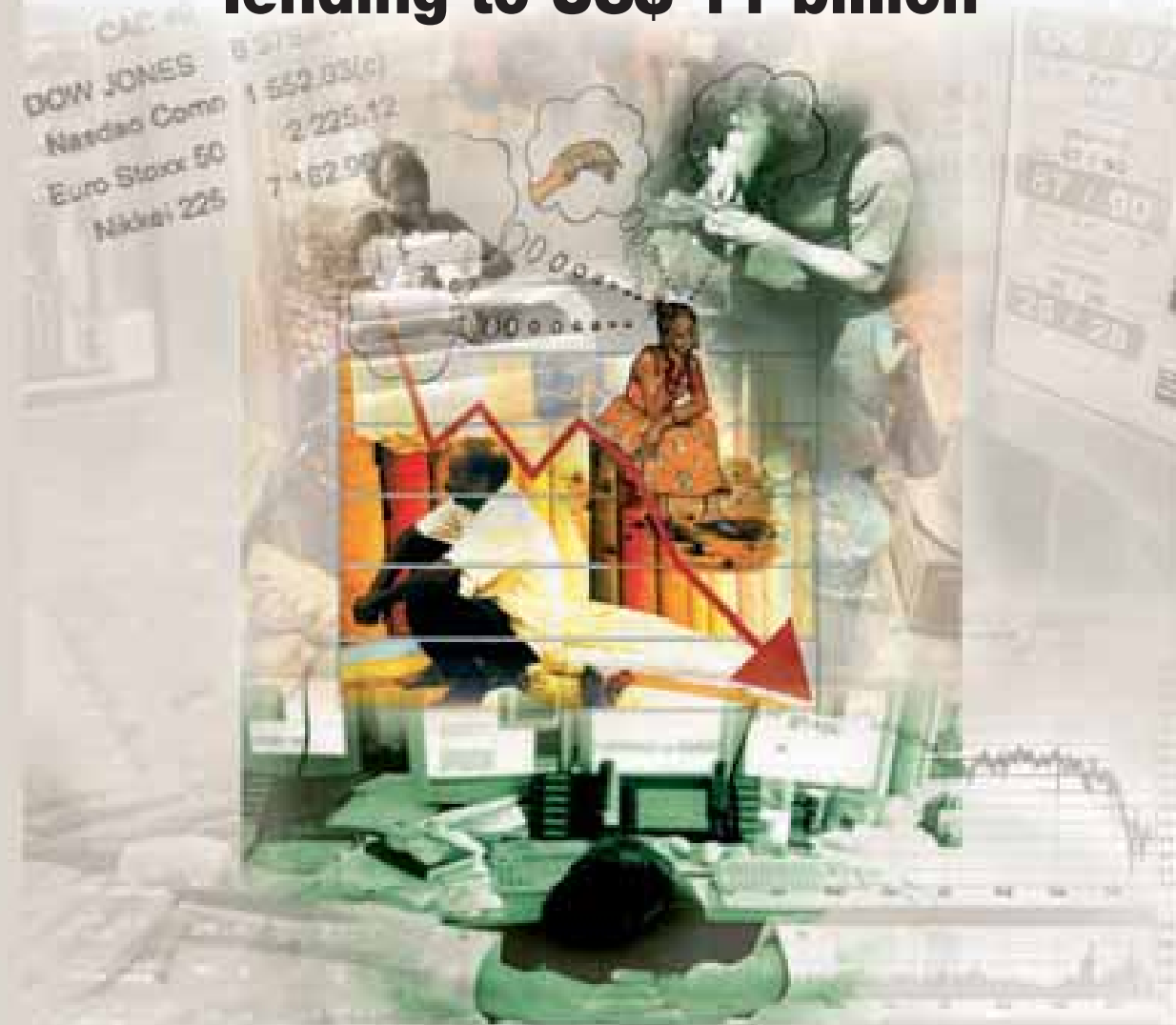
These are unprecedented times: times of challenge and above all times of rapid and complex change. But these are times of opportunity too, so leaders across the world must work together in common cause.

But it is also a time for economists, business leaders, academics and policymakers, activists, environmentalists and leaders of civil society to come together to debate, share and test ideas. It is time for all of us to work together to agree the action that will not only see us through the current crisis, but also ensure we emerge stronger. It is time for us to build tomorrow, today.

I believe this book is an invaluable contribution to this process and I thank all those who have contributed to it. ♦

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The G20 in the midst of the crisis

When crises originating in the developed world threaten to take a greater toll on the countries in the developing world, the G20 must act

By Luiz Inácio
Lula da Silva,
president, Brazil



We are in the midst of a global crisis of unprecedented gravity and unpredictable consequences. The world is living through a period of major economic

turbulence, political disorientation and paradigm shift. Yet inaction and paralysis are hardly an option. It is time to seek long-lasting, structural solutions. Otherwise, we risk seeing what is still largely a financial crisis turn into social and even political unrest. And there is a further risk: the poor, in developing countries, could become the main victims of a crisis for which they bear no responsibility.

The challenges before us are manifold and complex. Global markets must be stabilised, credit flows unblocked, the real economy stimulated, investments salvaged, and income and jobs protected. We need to preserve the hard-won social gains made in the developing world.

The first G20 summit in Washington, in November of last year, launched a new era of global governance. We must not go back on this commitment. At the London Summit on 2 April 2009, world opinion will be watching for signs of leadership, solidarity and co-operative spirit. This calls for a joint response, as well as collective and co-ordinated action.

In response to the immediate crisis, governments must adopt anti-cyclical policies to encourage aggregate demand, contain further economic contraction and, especially, preserve jobs. Anti-cyclical measures to stimulate the economy already add up to almost 2 per cent of the global gross domestic product. Only by reinforcing and co-ordinating these initiatives will a prolonged recession or even a global economic depression be avoided.

Getting trade flowing again is also a major part of the solution. Trade will truly become a catalyst for development in poor agricultural countries when the Doha round is successfully concluded. Protectionism will only aggravate things and bring about a domino effect that will be hard to reverse.

The state's central role in economic policy must

be recognised and reinforced. An overly deregulated financial system has fostered excesses and generated gross distortions. Trillions of dollars have simply vanished. Financial bankruptcy has contaminated the real economy, destroying millions of jobs and possibly destroying many more. Financial agents, often guided by a market-driven mindset, must not be allowed to drive the world economy over the edge.

It is imperative that measures to prevent crises be enhanced. Doing so requires putting in place rules that create greater systemic transparency. This will ensure that asset values and risk exposures, including those off the balance sheet, are duly measured and disclosed.

This will only happen if all systemically important financial institutions, markets and instruments are subjected to appropriate regulation and oversight, according to internationally defined standards applied on a national basis. Risk assessment agencies must focus on crisis management in all countries, not just developing ones. Multilateral co-ordination to abolish tax havens will greatly facilitate this effort. Furthermore, eliminating these grey areas will greatly aid in the fight against international organised crime and terrorism.

Clearly, the revamping of the global financial architecture cannot wait. International organisations and existing financial regulations and practices have failed the test of history. The G8 must progressively give way to alternative forums – such as the G20 – capable of providing the right answers to today's key challenges. A good start would be to set a precise negotiating mandate and a time frame for implementation.

Brazil is concerned with the tangible loss of credibility and legitimacy of the Bretton Woods institutions, which is why it has called for the wholesale reform of the International Monetary Fund (IMF) and the World Bank. These institutions were set up under conditions that have now been overtaken by current events. Their structure, regulations and tools must adjust to the new status of developing countries as indispensable actors in an increasingly interdependent world.

The first step is to undertake an ambitious review of the distribution of quotas and votes at these institutions. The voice of each country at both the IMF and the World Bank should be proportional to its economic clout and financial weight.

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The poor, in developing countries, could become the main victims of a crisis for which they bear no responsibility

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With regard to the IMF, a new framework is required to establish adequate standards of conditionality when providing financial support. Surveillance must be made more effective and fair, setting the same level of requirements and follow-up for developed and developing countries alike.

The World Bank and other multilateral development agencies must make full use of all the capital at their disposal to support anti-cyclical policies. In light of the current credit shortage and adverse prospects for the near future, these financial institutions must give priority to financing the needs of the developing world. If these countries are to come through the crisis relatively unscathed, social protection systems, as well as access to credit lines for foreign trade must be preserved.

We are going through an extremely difficult and challenging moment. Confidence in a reformed financial system must be restored. More importantly, growth must be rekindled and jobs preserved.

Working together we can achieve these goals. In the case of Brazil, there are significant achievements to be protected. After over two decades of stagnation, growth has picked up strongly in recent years. Critical to this was a far-reaching income-transfer policy that rescued more than 20 million Brazilians from extreme poverty. They are now consumers and citizens in an expanded market. Additionally, exports have grown fourfold. These are the critical engines driving Brazil's recent development spurt.

“Brazil’s success in riding out the turbulence mirrors the anti-cyclical policies adopted long before the crisis”

Brazil has also dispelled other myths. Critics who denied the possibility of combining strong growth with macroeconomic prudence have been confounded. Furthermore, the enhancement of the role of the state, with a view to overcoming strategic development challenges – such as in infrastructure – has not led to undue market intervention. Brazil's success so far in riding out the growing turbulence mirrors the anti-cyclical policies adopted long before the outbreak of the crisis. Brazil will stick to this course, while adapting to the changing environment and requirements of global co-ordination. Brazil will thus emerge from the crisis quickly and better prepared to face tomorrow's new world.

We must not become hostage to outdated paradigms that have not stood the test of a very trying time. Providing the right economic answers will require political will and open-mindedness to new approaches to forging a new world centred on human interests and values. ♦

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From Washington to London

It is time for the G20 leaders to make a concerted effort to halt the worsening global crisis with a package of measures to benefit both developed and developing nations

By Lee Myung-bak,
president, Republic
of Korea



The date of 15 November 2008 is truly a historic one. In the wake of the worst global financial and economic crisis since the Great Depression, leaders of the 20 largest economies gathered in Washington under the banner of a 'Summit on Financial Markets and the World Economy' to bring their wisdom together in an unprecedented effort to stabilise financial markets and deal with the current crisis, and begin a global recovery as fast as

possible. The G20 leaders agreed on co-ordinated macroeconomic policies to stimulate economies, a standstill to prevent protectionism and a 47-point action plan to reform the existing international financial system to prevent the recurrence of similar crises in the years ahead.

The G20 leaders will come together again at the London Summit on 2 April 2009, in the midst of a worsening global recession. Although it is important to reform the failed supervisory and regulatory system and the international financial architecture as a whole, the current economic distress urgently calls for the



immediate implementation of a concerted stimulus package. The international community, particularly its financial markets, has high expectations for the G20. Now is the time for the G20 leaders to show the world their firm determination to effect the recovery of the global economy with specific deliverables, both for the macroeconomic stimulus package and for the prevention of protectionism. In the process, relevant international organisations such as the International Monetary Fund (IMF), the World Trade Organization and the Organisation for Economic Co-operation and Development should be invited to provide their expertise and guidance.

The stimulus package will have to be big enough to alleviate the negative impacts of the global crisis and will be more effective if it is co-ordinated internationally. The IMF's recommendation to spend 2 per cent of gross domestic product (GDP) on the package makes a good minimum guideline. Korea itself is already implementing a stimulus package equivalent to 2.6 per cent of its GDP, with an additional 1 per cent or more being considered. That will enlarge the package to at least 3.6 per cent of GDP for the year of 2009 alone. Of the stimulus package, 60 per cent is to be disbursed during the first part, and a substantial portion of the package is designed to promote green growth.

Although trade has been the main engine of sustainable global growth, there is now a danger of spreading protectionism. At the Washington Summit, I strongly advocated that the G20 leaders commit themselves to standstill, halting any new barriers

A substantial portion of Korea's stimulus package is designed to promote green growth

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Although trade has been the main engine of sustainable global growth, there is now a danger of spreading protectionism

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to trade and investment. Such a commitment was reflected in the summit's declaration. However, the global recession is putting pressure on political leaders to resort to protectionist measures in trade as well as finance. This is in the interest of neither advanced nor emerging economies. To put the world economy back on track, in London the G20 leaders should not only reaffirm their commitment to free trade but also come up with concrete measures to put their commitment into effect.

The Washington Summit reminded the global community of the growing significance of the G20 in addressing major global economic issues. I believe that the G20, which is composed of developed and major emerging economies and accounts for 80 per cent of the global GDP, is a legitimate global body to cope with global economic and financial problems. The successful operation of the G20 ministers meeting since 1999 demonstrates that there are strong grounds for the G20 to continue at the summit level and to be developed as the 'global economic steering committee'.

In London, the leaders should reconfirm their determination to take whatever action is necessary for the recovery of the global economy. They should do so in definitive terms with a sense of urgency. Otherwise, the G20 London Summit might disappoint the international community, which is waiting for a message of hope in this global economic crisis. There is no crisis that cannot be overcome, however. I believe that, through the G20 process, the world can find the wisdom to transform the current crisis into a blessing and an opportunity to build a better world. ♦

France and the G20

France has displayed an economic pragmatism that is questioning perceived notions and established habits

By Christine Lagarde, minister of finance, France



In late January 2008, in front of a number of heads of state and government who had come together for the World Economic Forum in Davos, former Microsoft CEO Bill Gates delivered a memorable speech in which he called for a revision of capitalism to build “a creative capitalism”. A few months later, crisis struck our economic and financial world. The crisis clearly showed that such a revision was no longer merely desirable, but that it had become necessary and vital for our economies’ survival.

This year, the stars of Davos were not the fashionable financiers and trendy actors, but rather the states and their leaders, all united against a common challenge: to do everything possible to revitalise our economies and ensure their financing, and also to define the new rules of the game.

France pitted its strength against these challenges daily from July until December of 2008 during its presidency of the Council of the European Union. It did not hesitate to question preconceived notions and habits to defend a strategy that was both ambitious and necessary – bolstering the economy while placing the principles of regulation, transparency and accountability back at the heart of the financial system.

Only this global approach can relaunch economic activity and restore trust among financial institutions as well as the general public’s trust in the financial system. A true response to the crisis is needed, attacking the root of the problem and re-establishing a sound foundation for capitalism.

Starting with the Ecofin meeting in September 2008, I suggested to my colleagues that diminished economic activity should be met by using the budget weapon, which we were among the first to do.

In October, upon the presidency’s proposal, Europe agreed on a doctrine of action to support the financial sector. Its principles of transparency, respect for the rules of competition and support to any institution of systemic importance continue to be more relevant than ever.

“The crisis could have made us throw in the towel. Instead, it increased our energy tenfold”

In November, Europe asked for and obtained agreement for a G20 summit to be held in Washington. There, we defended a fundamental principle that was seconded by all: no jurisdiction, no market and no institution of systemic importance must escape regulation or surveillance. The summit was also the opportunity to state our desire that international institutions, the International Monetary Fund first and foremost, play a central role in helping the most fragile countries in the crisis. Europe acted in that way by providing financial support to Hungary and Latvia.

In December, we agreed that the European Union would provide a stimulus package worth 1.5 per cent of gross domestic product to revitalise its economy by relying on temporary, targeted and immediately effective measures.

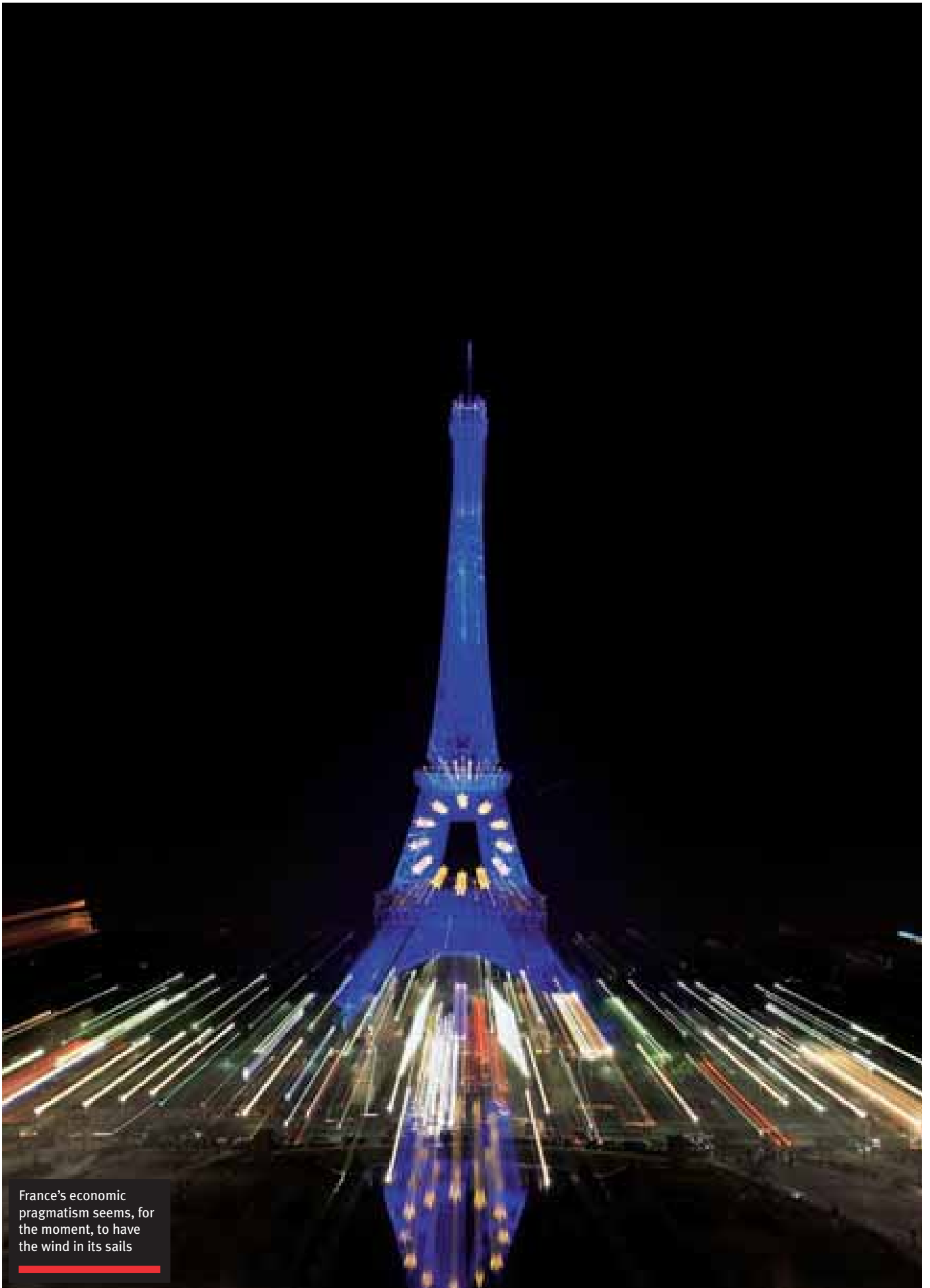
The crisis could have made us throw in the towel. Instead, it increased our energy tenfold – because the dangers looming over our institutions are far from resolved. What would our children say if we were unable to turn this crisis around to our advantage? It will doubtless leave lasting effects, but by proposing these structural measures we can prevent future generations from seeing the same causes reproduce the same effects.

In order to do so, we must continue working relentlessly and, above all, with strong ambition. We must convince our partners of the vital and urgent need to truly regulate and monitor global players, to ensure that capital adequacy and accounting standards do not aggravate the effects of economic cycles, that speculative funds are subjected to adapted surveillance and that credit rating agencies review their operating rules.

We must also put an end to the grey areas of the international financial system that undermine it, be they financial players or jurisdictions.

France’s economic pragmatism seems, for the moment, to have the wind in its sails. It is enabling us to weather the storm in a less lamentable state than many of our neighbours. Certain analysts see in it the best of defences against market volatility.

Nonetheless, despite this strong return of protective government, and despite pressing demands for clear, precise and unambiguous rules to govern trade relations and global finance, we must not lose sight of the fact that governments do not create wealth and prosperity: people do. Without accomplished entrepreneurs, without free inventors and without effective managers, a society stagnates. And if we are asking for more government intervention today, it is so that we can achieve less government intervention and a better world tomorrow. ♦



France's economic pragmatism seems, for the moment, to have the wind in its sails

Africa's crisis

After a period of growth across Africa, the global downturn is now affecting all developing countries and threatens to severely impact the fight against poverty

By Trevor Manuel,
minister of finance,
South Africa



The last decade has witnessed the dawn of hope on the African continent. Many African countries were building credibility by sticking to prudent macroeconomic policies, contributing to the achievement of the fastest growth rates since independence. But the global financial crisis, while it originated in developed countries, has meant a sudden and sharp increase in the borrowing costs of emerging markets and developing economies, including Africa. This comes in the wake of sharp rises in the prices of food and fuel imports, which pushed millions below the poverty line. And now Africa's terms of trade have suffered a strong negative shock.

These difficulties cannot be attributed to any significant changes in economic fundamentals. Most developing and emerging market countries entered 2008 with sound fundamentals and good financial cushions. They have continued to maintain relatively strong fiscal positions. Progress toward the Millennium Development Goals (MDGs) was uneven, but significant.

Notwithstanding this progress, the crisis is beginning to affect the real economies of developing countries. Africa's growth rate is projected to slow down to 3.5 per cent in 2009 from the annual average of more than 5 per cent achieved during the past decade. The negative impact of a protracted global downturn on trade and growth will have repercussions on the overall welfare of African populations and will undermine progress toward development objectives.

The immediate danger to development is the withdrawal of credit. For many African economies, capital markets have effectively closed, with investors fleeing toward the geographic source of the problem, spurred by the promise of government guarantees and massive bailouts. Although African banking systems are unlikely to be substantially affected by the crisis – the interbank market and the market for securitised or derivative instruments in African countries are small – the consequences of financial market turmoil for trade and growth will expose the financial systems of



developing countries to renewed danger. The current sharp declines in commodity prices after an extended boom and lower foreign demand will lead to a decline in foreign investment, remittances and foreign aid. Reduced foreign capital inflows (due to increased risk aversion and a flight to safety among investors) could have a serious impact on growth and poverty reduction in Africa.

As these inflows slow down or reverse, securities prices may decline, as has already happened in Nigeria, Kenya and South Africa. Infrastructure investment financed by foreign capital may also need to be postponed. Moreover, capital flow cutbacks may even extend to official development assistance, thus threatening the lives of hundreds of millions of Africans, particularly those on antiretroviral drugs who depend on foreign-sponsored HIV/AIDS programmes.

This is one of the reasons why – from an African point of view – a well-considered and globally co-ordinated response to the crisis is vital. The challenge

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For many African economies, capital markets have effectively closed, with investors fleeing toward the geographic source of the problem

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is to craft national responses that complement one another and sustain global growth and development. Such responses include maintaining access to capital markets, improving trade balances and securing sufficient and effective donor aid.

The G20 is well placed to co-ordinate such measures, and is capable of building the political will required to mobilise an effective response. Its membership, however, is not universal. South Africa is the only African country at the G20 table. This absence must be corrected at London and at future G20 summits, including through representation of the African Union and, more importantly, through the increased voice and representation of African countries in multilateral institutions.

The G20 played a significant role in concluding the second round of negotiations on quota and voice reform at the International Monetary Fund (IMF). By G20 leaders agreeing to advance the reform of the

The challenge is to craft national responses that sustain global growth and development

“ Measures must also be put in place to ensure emergency financing arrangements are readily available for low-income countries ”

Bretton Woods institutions further in order to give greater voice to developing countries, the G20 will continue to play an important role in ensuring the world's multilateral institutions reflect global realities better while also accommodating the concerns of low-income countries. In the long term, however, the goal should be to create a strong incentive for developed economies to consult African countries by reforming how decisions are made, including through a rebalancing of quota shares, and by restructuring the size and composition of the executive boards at both the IMF and the World Bank.

As the financial crisis spills over to affect countries' liquidity, African countries will need assistance in financing their development needs, particularly with regard to infrastructure. Measures must also be put in place to ensure emergency financing arrangements are readily available for low-income countries. In that regard, multilateral institutions will need not only the right instruments, but also sufficient resources – both human and capital. More are necessary to support a strong countercyclical response on the continent, so that African infrastructure investment and social safety nets do not become the ultimate victims of the crisis. Fortunately, the current crisis has helped to raise consciousness sufficiently to have more serious discussions about how to scale up the resources available to these institutions, and the G20 has committed to providing greater resources to ensure support for developing countries.

Finally, a commitment was made by the G20 leaders to refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions or implementing measures to stimulate exports inconsistent with those set out by the World Trade Organization. We in the G20 must be reminded of that commitment and of the dangers of beggar-thy-neighbour policies as national policymakers bolster their domestic economies. If we allow the centrifugal force of economic nationalism to triumph, the crisis will inevitably result in greater fragmentation. In the long run we will all lose. In the short run, the greatest burden will be borne by the poor and the marginalised, particularly in Africa. But if we use the crisis as an opportunity to render globalisation more effective, fairer and more sensitive to the development needs of Africa, both Africa and the world can gain. ♦

Key challenges

A concerted effort is needed now if the world's leaders are to break down ideological barriers and find lasting solutions

By The Rt Hon Paul Martin, former prime minister of Canada



Significant advances in international governance are sparked by crisis. This was true when the 1997-99 Asian financial crisis produced the G20 finance ministers. It was equally true of the G20's elevation to the leaders level last November in response to the worst financial crisis since the end of the Second World War.

In April, under the experienced chair of UK prime minister Gordon Brown, the G20 will hold its second summit. Expectations should be realistic about what it can achieve. More importantly, the summit must meet those expectations.

The G20 summit itself confirms that the G8's days as the world's steering committee have drawn to a close. Yet the world cannot afford a vacuum. Only a successful G20 will fill the void. The success or failure of the April encounter will determine how quickly confidence is rebuilt.

What, then, constitutes success? Certainly, issues such as Africa and climate change cannot be allowed to fall victim to the financial difficulties facing the developed world. The summit must state this unequivocally. Then there are the issues that will give a doubting world confidence that the G20 members will work together.

From what one reads of the debate so far, the fundamental differences between the parties are beginning to show. These differences must not prevail. On the one hand, this is an immediate crisis, which will not be resolved by half measures or timid stimulus. On the other hand, there is also the need to set in motion the responses to the financial parochialism, which lies at the root of today's problem. It is not too much to expect the leaders to deal with the issues arising out of both approaches.

First, all must agree to co-ordinate their efforts more efficiently now and for as long as the recession lasts. The participants must agree to resist the outright beggar-thy-neighbour tendencies they have demonstrated since 15 November 2008, despite their words to the contrary at that time. Furthermore, ideological barriers must not be allowed to further inhibit the recapitalisation of financial institutions. Quite simply, credit must flow for the financial crisis to end.

Second, the parties must resolve the serious inequities in the membership quotas of at least the Bretton Woods institutions and the Financial Stability Forum (FSF).

Third, global financial imbalances must be addressed. Some of the huge financial reserves of countries such as China must be better directed toward satisfying internal demand. The United States must stop blaming others for its unsustainable credit spree.

Today's crisis is not only a banking crisis. It arises from the fact that yesterday's buyer of last resort – the US consumer who single-handedly brought the 1997-99 Asian financial crisis to an end – is now tapped out. As a result, deficit-ridden governments in North America and Europe have replaced the US consumer. It would be far better if that consumer were replaced by consumers in Asia and elsewhere.

Fourth, the parties must recognise that part of the restoration of confidence will come from the demonstration that governments can act to prevent or mitigate a repeat of the current mess.

This brings me to the G20's role in furthering comprehensive financial regulation and international monitoring of financial institutions. We have all watched aghast at the failure of adequate regulation as the great European and US financial icons have turned to dust in the blink of an eye. Future problems, however, extend well beyond those sectors that were thought to be regulated. They also include those now exempt from regulation, such as hedge funds, private equity funds, credit rating agencies and the shadow banking system. Thus the summit should clearly state that any financial activity that presents a systemic risk will no longer be free from oversight.

I do not believe a single global regulator is workable. It could never have the domestic insight and intuition required to provide adequate national regulation. Thus regulation should be the responsibility of individual governments.

However, the spread of financial networks into every corner of the world makes it impossible for sound national regulation to remain sufficient on its own.

“The summit should clearly state that any financial activity that presents a systemic risk will no longer be free from oversight”



National regulation, almost by definition, disregards the threat of global contagion. It also cannot deal adequately with gaps in the global financial system, some of which are the result of deregulation.

The fundamental problem is not just the exposure to risk within a country's borders. It is the cross-exposure to risk that transcends those borders. For instance, someone unable to afford it buys a house in California in 2004 and four years later small municipalities in northern Norway declare bankruptcy.

Thus the scope and the competence of domestic regulation should be ensured by an international body. And major global financial institutions operating in the world's important markets should be subject to specific international supervision.

In short, a mandatory global monitoring mechanism is clearly necessary. But many argue it is not. At the core of this resistance is a counterproductive and outdated definition of sovereignty. The Treaty of Westphalia, which defined national sovereignty in 1648, limited it to sovereign rights. However, such is the seamlessness of global capital markets in 2009 that the definition must now include sovereign duties as well.

Oliver Wendell Holmes said, "My right to swing my arm stops at the other man's nose." In today's world that distance has almost disappeared.

When the market created toxic assets and US and European players sold them around the world

A mandatory global monitoring mechanism is clearly necessary: queuing outside the Bank of Antigua, implicated in the alleged Allen Stanford fraud

to everyone's detriment, they infringed upon the sovereignty of every country affected by their failure to exercise minimum standards of prudence.

During the Asian financial crisis, Canada proposed that each country accept a peer review of its financial sector regulatory processes. Canada volunteered to undergo the first review. This Financial Sector Assessment Program (FSAP) was done under the aegis of the International Monetary Fund.

Each G7 country has since undergone the review with the exception of the United States. Would we be in such a mess if experienced external practitioners had reviewed the US regulatory system?

The FSAP was set up on a voluntary basis and only examined national systems. As a first step it must now become mandatory and examine cross-border financial flows. Such a form of international monitoring does not intrude on sovereignty. Indeed, it protects sovereignty.

When the Chinese and Indian economies become as large as America's and a Chinese hedge fund fails, or a mortgage meltdown occurs in India, or a sovereign wealth fund speculates unwisely, where will the effects of these financial tsunamis end? Who will deal with them, if countries hide behind their sovereignty to prevent international co-operation?

Strong global institutions do not infringe on national sovereignty. They enable governments to protect their citizens by solving problems that transcend national borders. ♦

London Summit: acting for change

An ambitious agenda will build on, and seek to implement, commitments made at Washington. A message of hope is overdue

By John Kirton,
director, G20
Research Group

On 2 April 2009, the leaders of the G20 countries will assemble in London for their second summit, following the first on 14-15 November 2008 in Washington DC.

The G20 combines as equals the established G8 powers of the United States, Japan, Germany, Britain, France, Italy, Canada, Russia and the European Union; the rapidly emerging economies of China, India, Brazil, Mexico and South Africa; the other systemically significant countries of Argentina, Australia, Indonesia, Saudi Arabia, South Korea and Turkey; and the International Monetary Fund (IMF) and the World Bank. This unique group, representing much of the world's population, territory, economy, finance and trade, brings great diversity in regional perspective, level of development, economic structure, political system, language and religion to its search for consensus on how to guide today's troubled world. It is thus well positioned to lead the global community in confronting the unprecedented economic and financial crisis now afflicting the world.

In London, the G20 leaders and their invited guests will grapple with an ambitious, interlinked agenda embracing macroeconomic stimulus, financial regulation, international financial institution reform, trade, development and climate change. They will seek to implement and reinforce the 95 commitments – including 47 specific action items – agreed to at their first summit. They hope to send a strong signal of confidence, backed by real action, to break the cycle of fear paralysing so many businesspeople, investors and consumers around the world.

This will not be easy. While most G20 members have kept their promises from Washington on stimulus, regulation and reform, some have violated their clear



commitment not to introduce any new protectionist trade or investment measures. Moreover, all the established G20 countries are plummeting into a severe and prospectively protracted recession that has spread to emerging economies, compounding the credit and financial crisis, threatening to unleash a new wave of sovereign defaults and imperilling efforts to reduce poverty and control climate change. While all look to America's new president, Barack Obama, to provide visionary leadership, there are differences of approach within Europe, between Europe and America, between the established and emerging G20 members, and among the leaders, their legislators and business professionals in some G20 states. Facing the worst crisis since the Great Depression, this new group of leaders from very diverse countries will be called upon to co-operate boldly and wisely as never before.

Their first challenge comes in delivering, reinforcing and co-ordinating the fiscal and monetary stimulus required to halt and reverse the deep, synchronised recession still gathering force. They have already delivered most of the 2 per cent of gross domestic

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They hope to send a strong signal of confidence, backed by real action, to break the cycle of fear paralysing many

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UK prime minister Gordon Brown is the first European leader to visit US president Barack Obama, March 2009

product in the additional fiscal stimulus that the IMF said was needed. But they will need to do more, do it less unilaterally and do it in ways that assure their citizens and creditors that fiscal sustainability will eventually be restored, that good jobs will soon return and that carbon will be reduced starting now. With monetary policy rates near zero in most established economies, the leaders will also need, for the first time, to construct and co-ordinate unconventional instruments and quantitative easing in an effective way. Here they are likely to succeed, if they can conquer the uncertainty and complexity they commonly face.

The second challenge for the G20 leaders is to modernise and harmonise their domestic financial regulation, across all the many sectors advanced economies now contain. The workings of today's hedge, private equity and sovereign wealth funds, as well as the derivatives and illicit financial markets, have their mysteries, especially when they cross national boundaries and intersect with the more familiar commercial banks, investment banks, accounting firms, credit rating agencies, insurance companies and mutual

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The second challenge is to modernise and harmonise their domestic financial regulation,

across all sectors”

and pension funds. But here the primary problem lies in competing interests, with those enjoying the Anglo-Saxon market model preferring light, national regulation with international supervision, and those with bank-centred, state-guided business systems seeking heavier, more supranational regulation they hope their national governments can control. G20 leaders should find it easy to agree that all parts of the financial system should be supervised, regulated and transparent, that pro-cyclical incentives should be contained, that private sector executive compensation should be limited and that illicit finance should stop. But deciding how and where to do this will be difficult, especially with some in Europe wanting to abolish hedge funds and other derivatives outright. Even where G20 governments act on their common determination to revise fair value accounting, replace the role of credit rating agencies in their regulatory regimes and reform their housing finance markets, it is unclear what the alternatives and their results will be.

The third challenge of reforming international financial institutions is even more difficult, for here the status, prerogatives and sovereignty of states are at stake in their starkest form. All agree in principle that IMF resources should be doubled and its instruments updated and that emerging powers should have greater weight in the Financial Stability Forum, the IMF and World Bank. But there is no consensus on how many and who should be added, and how far and fast this expansion should go. With so many Europeans and others joining G20 leaders at the summit, it will not be easy to reach a deal that reflects a world where Asia and America are rising and where Africa needs a stronger voice. It will even be difficult to agree to have the executive heads of the IMF and the World Bank transparently chosen on the basis of competence through a process in which all can compete. The G20 leaders will thus have good reasons to call another summit, to keep at these tough tasks.

The fourth challenge of combating protectionism calls G20 leaders to succeed where the more compact and like-minded G7 summits did for so many years. Here they must monitor, stop and reverse both traditional protectionism and the new, equally pernicious forms arising from bank bailouts and guarantees, auto sector subsidies and restrictions on foreign workers and the remittances they send to their poor relatives back home. On their fifth challenge, they must move the long-overdue Doha Development Agenda forward, get trade finance and investment flowing southward, and give emerging and developing countries the financial support they need. And for their sixth challenge of climate change, they must craft their economic, financial and institutional actions in ways that reduce carbon emissions and reinforce carbon sinks on a global scale.

The unprecedented suddenness, scope, complexity and uncertainty of this crisis should inspire all G20 governors to rise to these formidable challenges. The world will look for real leadership from President Barack Obama from America, UK prime minister Gordon Brown as host from Europe and China's president, Hu Jintao from Asia. The three must act together to deliver the transformation all can trust. ♦



Competing Gs?

The increased importance of the G20 is calling into question the role of the G8. Is the G20 establishing itself as the hub of global policymaking?

By Andrew F Cooper, associate director and distinguished fellow, The Centre for International Governance Innovation

The G20 leaders format appears to be an ascendant form of summitry. Acting as an economic crisis committee, the G20 has served an important symbolic function, sending a clear message that leaders of an extended group of states across the North-South divide recognise the gravity of the fallout from the financial and economic shocks. It also provides significant instrumental value, with its extended plan of action in a host of technical areas.

It is thus easy to suggest that the G20 summit constitutes a mechanism ready to seize the moment, turning a structural dilemma into institutional innovation and creative initiatives. The initial November 2008 meeting in Washington – and the momentum toward this second gathering in London in early April 2009 – has sent a sharp message that world leaders prefer hanging together through collective efforts to

hanging separately through instinctive but short-sighted unilateral efforts. With its solid association via the G20 finance machinery and the International Monetary Fund (IMF) – another institution that has revitalised itself in a time of crisis – the G20 not only boasts technical capabilities, but is also favourably positioned as a catalyst for wider technical reform.

Yet, for all of these early positive attributes, some constraints remain before the G20 can emerge as the summit of summits.

The G20 as a hub of global policymaking and governance is premised on the assumption that leaders (as opposed to finance ministers and central bank governors) will maintain their focus on the solutions as well as the problems associated with the financial crisis. But most of these remedies are highly technical, whether dealing with a college of supervisors, the Basel banking standards or the International Organization of Securities Commissions. Will this agenda continue to contain the right



The G20 summit appears to have made progress on several technical items relating to regulation, standards and surveillance

ingredients necessary to get all G20 leaders to attend? The London meeting counts in part on the star power of its host – UK prime minister Gordon Brown. This is only amplified by the first major appearance on the world stage of United States president Barack Obama. But as the crisis deepens, will there emerge a sense of G20 fatigue beyond the April summit?

The G20 summit is not free from criticism, particularly of its representational claims or its performance quality. As a replica of the G20 finance forum, the G20 leaders format has the merit of convenience while glossing over membership conditions. Argentina and Turkey were included in the G20 finance largely because of their position as debtor states, but does this rationale still stand up? The G20 also privileges Saudi Arabia as a wealthy Arab country, as opposed to others with greater claims of representation, most notably Egypt. And the issue of European over-representation continues to be sensitive. French president Nicolas Sarkozy may be lauded for his diplomatic skills in adding Spanish and Dutch participants at the Washington meeting – along with the presence of the four European G8 members and the European Union president. However, this imbalance creates a backlash, prominently from the African Union (AU), demanding equal representation and renewed calls from the global South for IMF reform to address the disproportionate European weight.

In terms of performance, the G20 summit appears to have made good progress on several technical items relating to regulation, standards and surveillance. Missing is a signal from the G20 that it is linking

institutional reform to the issue of inclusiveness, in particular to the emerging countries with the highest degree of global economic or diplomatic reach. A case in point is the apparent lack of progress on the expansion of the Financial Stability Forum, which includes Hong Kong but not China.

The ascendancy of the G20 has brought into question the future of the G8 as the established hub of global policymaking and governance.

On the face of it, the G8 has difficulty justifying itself as the 'likeminded' group – due to the presence in its ranks of Russia – particularly in a time of economic crisis with all of its global ramifications. Yet there are serious reservations about any form of 'big bang' membership expansion. To its credit, as host of the 2009 G8 summit, Italy has shown some considerable agility in minimising the deficiencies and maximising the comparative advantages of this summit process vis-à-vis the G20.

Italy has emphasised the presence of the big emerging states, namely China, India, Brazil, South Africa and Mexico, the self-described G5. This group was formally convened at the 2007 Heiligendamm Summit with a two-year mandate to build an extended dialogue on a number of key issue areas. While low key, this process – facilitated by the Organisation for Economic Co-operation and Development – has been vital in going beyond the image of outreach. The entire second day of the 2009 Italian-hosted G8 will be given over to a meeting between the core membership and the G5. Significantly, in another break from the G20 formula, Egypt is added to this mix.

The third day will be devoted to extending the discussions both on a substantive and an inclusiveness basis. The 16 members of the Major Economies Meeting on Energy Security and Climate Change (MEM-16), as convened at the Japan-hosted 2008 Hokkaido Summit – will once again be invited for talks on the climate change agenda. As in the case of the G20, the AU president (the mercurial Colonel Muammar Ghaddafi) is also invited. This form of participation gets around some of the problem related to selecting African representation beyond South Africa (and now Egypt). It also signals that Africa will not be forgotten by the G8 amid the financial crisis.

As the nature of their relationship plays out, some element of tension between the G20 and the G8 is inevitable. If the core components of the G8's traditional economic mandate are carved out to the G20, does this weaken the G8? Or does it create a better division of labour where the G8 can concentrate on other important areas? The Italian summit suggests the latter by its focus on development as well as security issues (including Afghanistan). Or, alternatively, if fatigue sets in on the G20 after April 2009, will the G8 be able to grab back the economic agenda as an ongoing summit process that can deal with the extended financial shock waves?

If so, the G8 will also have to regain some of the legitimacy associated with the G20 – due to its more representative membership – and signal that it is ready to provide a comprehensive vision for 21st-century policy making and global governance. ♦



A continuing process

Regulation cannot specify the exact steps to take and can only determine the context in which activities are carried out

By Paolo Savona, professor emeritus, geopolitical economy and chair, Unicredit Banca di Roma

Since the outbreak of the financial crisis, there have been insistent calls for stricter controls on intermediaries. But these calls have not been accompanied by sound proposals for the new regulations required to prevent a recurrence of the crisis. The conclusions of the 2008 G20 summit in Washington indicate the need for stricter controls, but not their substance.

When they meet again in London, in April, the G20 leaders should consider the following four points.

First, the competitive market is not a natural consequence of human behaviour but a legal

creation. Rules for its operation must be established and supervised.

Second, unlike other markets, the money and financial markets are not constricted by the scarcity of resources but consist of mere ledger entries, the product of bookkeepers' pens. These markets have no ability to control their own size by self-regulation.

Third, no rule or penalty can prevent abuse. Only ethical conduct can, but because, according to Gresham's law, bad money crowds out good, so in finance bad products drive out good ones. The example of those who break or evade the rules holds sway over those who observe them.

Fourth, when rules are established, the market always finds a way to circumvent them. Regulatory

activity must therefore be a continuous process; it cannot await instructions from any summit of leaders.

According to the logic of the competitive market, regulation cannot specify what is to be done or how but can only determine the context in which activities are carried on. If it oversteps this limit, the market ceases to be the place for the most rational management of scarce resources, and the costs to society increase.

Practical experience and theoretical study over the course of nearly two centuries of struggle between the currency school, favourable to controls, and the banking school, opposed to controls, have led to the establishment of rules for the conduct of banking as an indispensable tool for controlling the money supply. The creation of a monetary base and the setting of reserve requirements and official interest rates have been the main tools of monetary policy. In such a system the monetary authorities are responsible for guiding the growth of banks, assisted by supervisory authorities. The shift from banks' reserve requirements to capital adequacy ratios transferred much of this responsibility to the money market, where a decision to finance a capital increase for a given bank can be crucial to its growth and, possibly, its very survival.

No comparable development has occurred within the financial market. Rules for transparency, the oversight of the supervisory authorities and reciprocal control by market participants themselves, together with the vigilance of the credit rating agencies, would ensure stability. For financial innovations – from derivatives to 'complex' or 'structured' securities – rules and oversight were even milder or, as in the case of over-the-counter markets, totally absent.

While controls on banks worked better than the others, the banks contributed to the current crisis. Disparities in regulation between different financial market segments ultimately moved the product of banks' lending activity to the financial markets, and from there toward innovative finance. Typically, banks abandoned the traditional originate-to-hold business model in favour of an originate-to-distribute approach, making the lender no longer accountable and shifting the risk onto the final purchasers of the securities, whether intermediaries or individual investors.

The heart of the process that created the current crisis lies in the ethical shortcomings of market participants in the form of a failure to assess creditworthiness. The supervisory authorities and oversight agencies followed a 'benign neglect' approach to real growth, while most financial mathematicians and economists failed to warn of the mounting risks and the dangers that threatened final investors.

A rare concomitance of adverse factors caused a crisis of confidence that was transmitted to the real economy, shattering budgets as governments moved to ward off the failure of banks and the collapse of employment. Economic policy was yoked to the service of system stability, no longer an instrument for non-inflationary and sustainable growth. The pressures for legislative intervention strengthened. But while such action might satisfy the desire for

“ The same regulatory provisions must apply to both monetary and financial activities ”


justice, it cannot guarantee the protection of investors.

The backdrop to this crisis is the unresolved geopolitical problem of external payment deficits of the United States, Britain, Spain and Ireland, which must be financed by the surplus savings of China, Germany, Russia and the oil-producing countries. Until these disequilibria are corrected, there can be no stability in financial markets: the management of official reserves (including sovereign wealth funds), exchange rate variations and interest rate reactions will prevail over the fundamentals of real exchange.

Moreover, every security and every financial claim has value only for its liquidity – that is, the speed with which it can be converted into cash. This concept of market performance, known as 'shortism', has come to dominate national and global behaviour: it is the tendency to lose sight of the future and focus on short-term results. In today's markets, its prevalence suggests that every aspect of the market is interpreted in monetary terms. Consequently, the same regulatory provisions must apply to both monetary and financial activities. But because controls must protect individual savers and investors – and not entrepreneurs and asset managers, who are perfectly capable of defending themselves and their own interests – regulation must focus almost exclusively on the former group.

No regulation and no supervisory authority can fully protect savers, and the promise of protection must not create the illusion that they are protected – as the commitment of the G20 summit in Washington and the repeated proclamations of national authorities would suggest. The investor must understand that a switch from riskless to risky assets may result in the loss of part or all of the investment. Are there truly risk-free assets? As with Argentinean bonds, not even government securities are free of risk.

The European Union's directive on bank deposit protection schemes distinguishes between uninformed and informed depositors, with a threshold pragmatically set at €100,000 in bank deposits. The solution could be to offer a 100 per cent guarantee on riskless bank deposits and guaranteed government securities up to a certain amount and to pledge that, for larger amounts, governments will contribute to ensure full information on risk but will not intervene. This approach would make it possible both to reach an international agreement on both protection for guaranteed securities and the financing of guarantee funds and – last but not least – would educate investors about responsibility. ♦



The creation of a monetary base and official interest rates have been the main tools of monetary policy

Competing approaches

There are conflicting views on the best way forward for banking supervision. One thing alone is certain: supervision will be stringent and testing

By Natasha de Tèran,
Financial News

Now that the horse has well and truly bolted, a complete overhaul of security is under discussion back at the stable. As much energy is now being poured into devising more effective regulatory systems for the future as is being expended on recapturing the errant steed and bringing it back into harness.

Despite all this, there seems to be precious little conviction about what shape banking supervision will take. Agreement has so far centred on a few issues: banking sector remuneration must be toned down and encourage longer-term behaviour; bank capital measures must be revisited; regulators need to be given a stronger armoury, including better-equipped staff; internal stress testing and pricing assumptions must be overhauled and continually revisited. If those are easy, only two other real conclusions can be drawn at this stage: banking supervision in the future will be much more stringent and the struggle for supervisory hegemony will be hard-fought.

On the one hand, politicians and regulators insist that the global nature of the crisis means that supranational structures are necessary, that co-operation must be enhanced at both regional and international levels if regulatory arbitrage is to be avoided and that dialogue must be fluid at all levels. On the other, national politicians and regulators resist the very idea of ceding any power. There would seem as many instances of regulatory protectionism as there are of regulatory collaboration.

None of this is new. What differs is both the degree of urgency and the need to accommodate apparently irreconcilable discrepancies between the national interests of the taxpayers who have funded so many banking bailouts and the international workings of the banking market itself.

Sir Howard Davies, director of the London School of Economics and former head of the Financial Services Authority, has summed up the problem neatly with respect to Europe: "This is not an easy problem to resolve. The answer should be a single regulatory authority of some kind, at least for the purposes of authorising banks and determining the rules under which they operate. That will be politically extremely difficult and the United Kingdom government, for one, will certainly resist it."

At the macro level, the G20 summit in November 2008 in Washington set down a strict timetable. Various working groups are committed to meeting these deadlines in preparation for the follow-up summit in London on 2 April. The Financial Stability Forum, an offshoot of the G7, is meanwhile considered the appropriate body for dealing with the regulatory issue. It is already widening its brief to embrace the G20.

In Europe, serious work is also afoot. The mood-music from the European Commission suggests that European Union-wide regulation is favoured, as well as a wider remit for the European Central Bank (ECB). The European Commission's internal market commissioner, Charlie McCreevy, has pointed out the growing divergence between EU supervisory structures and market developments. He has lamented the fact that EU supervisory structures remain primarily national, whereas market developments are becoming ever more intertwined at both the European and the international level. There have been "significant co-ordination problems and conflicts of interest between member states". He has also stated that the status quo is "not an option".

As far as banking regulation in Europe goes, the European Commission expert group is compiling a report – named after its chair, Jacques de Larosière, a former managing director of the International Monetary Fund – that looks at the future of financial supervision and regulation and recommends how to strengthen European supervisory arrangements across all financial sectors. Initial findings will be published before the April G20 summit.

Speaking in Brussels in January 2009, Joaquín Almunia, the European commissioner for economic and monetary policy, made clear his hopes for

“ There would seem as many instances of regulatory protectionism as there are of regulatory collaboration ”



the review's findings: "I am hoping for ambitious proposals that – within the limits of the Treaty [of Maastricht] – will set out concrete actions to strengthen European supervisory arrangements. There is now a real necessity to have a single supervisory agency at EU level."

Even within Europe's 27-country bloc, however, there are wildly differing views. At the same meeting in Brussels, Eddy Wymeersch, chair of the Committee of European Securities Regulators, a body made up of national market supervisors from EU states, said that an agency was not the right choice. "It would not be

"The answer should be a single regulatory authority, at least for the purposes of authorising banks and determining the rules under which they operate", Sir Howard Davies, director, London School of Economics

independent enough. It has to be something like an ECB-type structure," he said.

The City of London Corporation's submission to de Larosière, meanwhile, flags just how contrary the UK's thinking might be. The corporation called for the colleges of supervisors to be reinforced, for colleges to be established for all leading cross-border financial institutions and for a lead supervisor role to be established across Europe. It backed a more integrated EU approach, but echoed neither Almunia's call for a single European regulatory agency nor Wymeersch's for an ECB-type structure. ♦

Credit rating agencies: setting standards

Renewing confidence in the credit rating industry is a priority, but ratings are not the only consideration for the wise investor

By Deven Sharma, president, Standard & Poor's

India's founding prime minister, Jawaharlal Nehru, once said of crises that "when they occur [they] have at least this advantage, that they force us to think." The current credit crunch has certainly done that. Understandably, the institutions that underpin our financial markets have been put under a microscope. And, appropriately, that includes the credit rating agencies that provide a common basis for analysing credit risk.

Indeed, some have questioned the need for rating agencies at all. Some have disputed the business model under which rating agencies are paid by issuers and provide analysis to the investing public free of charge. But in a global economy valued at tens of trillions of dollars and characterised by fast-changing markets, industries and issuers, the information that rating agencies gather and analyse is simply too voluminous for many market participants to process themselves in a timely and cost-efficient manner. Common credit assessment significantly reduces inefficiencies and combats information asymmetry between issuers and investors. If rating agencies did not exist, something would have to replace them. Market participants must recognise that while ratings are a valuable tool, they should not stand alone in an investor's toolbox. Ratings do not address many of the additional risks that investors need to consider when buying or selling a security. These risks include liquidity, volatility, correlation and duration.

Standard & Poor's recognises that the issuer-pays model, which it has been using for nearly 40 years, raises concerns about creating potential conflicts

of interest. That said, the two most frequently posed alternative business models – public sector or subscriber-paid models – also contain their own possible conflicts and limitations. In many cases, investors prefer lower ratings on the same securities on which issuers might want higher ratings. Government, as issuer, investor and overall governor and regulator of the economy, can have its own interest in ratings decisions. Therefore, the key is to determine how to manage these conflicts most effectively.

The current regulatory structure reflects the state of the markets nearly 70 years ago, with banks, securities firms and insurance companies engaging 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. New, unregulated players have also entered the scene and products have been developed that fall outside the regulatory process. These developments suggest the need for reform of the global financial regulatory architecture. The regulations governing credit rating agencies must be part of that.

What might a new regulatory approach to rating agencies look like? For one thing, it would be consistent across jurisdictions, reflecting the interconnected global economy in which credit rating agencies conduct business. Investors need a level playing field, which is why conflicting national or regional requirements cannot be allowed to impair the interests of the marketplace. One model is the Code of Conduct Fundamentals for Credit Rating Agencies prepared by the International Organization of Securities Commissions (IOSCO). National regulators should be cautious about exceeding IOSCO standards. No one will benefit from an unduly complicated regulatory framework.

How could regulators provide a seamless approach across all jurisdictions in which a credit rating agency conducts business? Three elements are key to any global approach: consistency, co-operation and information shared among regulators with appropriate regard for confidentiality. An important addition would be for regulators to embrace a 'passport' or recognition system. Rating agencies would register in their principal business jurisdiction, adopting the appropriate business conduct standards. Using this passport, an agency's rating would be approved for use under the laws and regulations of other jurisdictions (pursuant to a notice filed with the local regulator).

What specific practices should credit rating agencies adhere to? Most importantly, they should provide transparency. For example, rating agencies should use a global rating scale that constitutes a language common to all major sectors of the economy and regions of the world. Regulation can also require disclosure of rating performance statistics, so market participants can compare ratings across industries, jurisdictions and agencies. Rating agencies should publicly issue performance measurement statistics, spell out policies and procedures on the use and transparency of models and assumptions, and disclose the basis of rating opinions – enabling investors to question or challenge them. Standard &



Ratings do not address many of the additional risks that investors need to consider when buying or selling a security





Poor's rating services have already adopted a number of these practices.

Rating agencies should also provide transparency into their own organisational structures – assisting regulators in assessing factors such as the firm's financial viability, independence and separation of commercial and analytical functions. Moreover, rating agencies should publicly disclose a detailed code of ethics, including a description of how it will be enforced – with an ombudsman or other independent officer available to address concerns and complaints. A regulatory regime could also require rating agencies to implement robust standards for analyst and employee independence as well as procedures for eliminating or mitigating potential conflicts of interest.

A credit rating agency's criteria and methodologies must be an open book. The systems, standards, assumptions and models used to determine ratings should be easily available to market participants. In addition, rating agencies should publish scenario analyses, so investors understand why ratings might change.

Another possibility is to increase the disclosure requirements of issuers, particularly with regard to structured finance instruments and portfolios. There is a misplaced view among some market participants that credit rating agencies are the gatekeepers of this information, when in fact the issuer or underwriter of a structured security is best positioned to disclose all appropriate information to the markets. Levelling the playing field and requiring structured product issuers to disclose at least as much information as corporate

Stephen Joynt, CEO of Fitch Ratings, Raymond McDaniel, CEO of Moody's, and Deven Sharma, president of Standard & Poor's, are sworn before the House Oversight and Government Reform Committee, October 2008, Washington DC

“ The bottom line is that renewed confidence in the ratings industry depends on agencies' analytical independence from all external influences ”

issuers would provide immense benefit to investors and dramatically increase transparency in the structured finance markets. Any information that is determined to be appropriate to be disclosed should be released by the issuers or underwriters to the market in a broad and timely manner.

The bottom line is that renewed confidence in the ratings industry depends on agencies' analytical independence from all external influences. Therefore, regulatory oversight should be thorough and effective, without interfering in a rating agency's ability to respond to market needs; nor should it dictate methodology or second-guess rating opinions.

Consistent, high-quality standards such as these – practical and flexible enough to serve global markets – will enhance the credit rating process and help restore investor confidence in the marketplace. ♦

Azerbaijan: Stable growth amidst challenges

Dr. Jahangir F. Hajiyevev, Chairman of the Board, International Bank of Azerbaijan

Azerbaijan and its banking system have fared well during the global financial crisis. Early moves to reduce debt, prudential government policies and conservative asset management have all helped Baku avoid the twin deficits of debt and export imbalances hobbling most emerging markets. Azerbaijan's financial system and economy remain stable and growth oriented. Baku's leadership has managed to maintain strong liquidity and bolster national reserves as market stabilisers, if needed. Initially insulated by its less mature financial systems, the crisis, ironically, has helped create a healthy slowdown of rapid economic growth and stem double-digit inflation.

Economic pressures, nevertheless, have downsized record growth rates in the fastest-growing economy in the world by half. The IMF projects 6 per cent growth in non-oil sector real gross domestic product and 18 per cent in the energy sector for 2009, but this is against 2 per cent expected growth for the Central Asia and Caucasus region, and 0 per cent worldwide. Azerbaijan remains poised for growth but at a more measured and fiscally-disciplined pace amid global market challenges.

The International Bank of Azerbaijan (IBA) is doing its part to contribute to stability, growth and job creation. The bank manages \$5.2 billion in total assets and is the largest bank in Azerbaijan and the region. As the National Development Bank of Azerbaijan, IBA is deeply committed to the accelerated pace of economic diversification in non-oil sector growth and of the private sector reforms that helped earn Azerbaijan the World Bank's ranking as the "top business reformer globally" in its *Doing Business Report 2009* annual index of 181 countries. Improvements in the ease of doing business are enhancing the development of an entrepreneurial culture and the small- to medium-sized businesses that give true dynamism and resiliency to markets.

Baku is navigating the crisis and is committed to developing its infrastructure as a financial and business hub for the region. IBA paid \$800,000 million of \$1 billion in debt in 2008 on schedule and without assistance. We offer domestic and international investors strategic advantages:

- Stable performance and a customer base that continues to grow;
- Status as the largest creditor of the national economy;
- Confirmed ratings from Fitch's of BB+ and Moody's at Baa2;
- A well diversified asset base;
- 42 per cent of the country's bank assets and 50 per cent of its customers;
- The strong support and trust of its customers, investors and shareholders;
- Continued expansion of branch networks and international offices.

IBA invests in strategic and sustainable assets that enhance economic stability and job creation for the long term. We are beginning to move beyond an energy-dependent economy. Large- and medium-scale infrastructure finance of regional



railroads, airports and roads in many areas are reaching completion and opening up remote regions, as well as the first direct rail links from Baku to London, through Georgia and Turkey, for the first time since the 19th Century.

IBA's investments in agriculture have revitalised or created new farming industries. These investments will soon bring 42,000 hectares of new land under cultivation among cotton, hazelnut, tobacco and silk production projects, creating thousands of jobs. These sectors create critical supply chains of employment for skilled and unskilled labor. The region's first Methanol and fertilizer plant will soon become operational as well as the region's first biofuel venture to produce cottonseed oil. Environmental rehabilitation, through both brownfield and greenfield projects, under the State Oil Company of Azerbaijan (SOCAR) and the World Bank, are bringing very new state-of-the-art technologies to the clean up of the Bay of Baku on the Caspian Sea.

Azerbaijan has fared well but this amplifies our responsibility to use resources vigilantly. At IBA, we believe that bankers are guarantors of the public trust and that Azerbaijan can serve as the anchor for economic stability in the region.



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Deriving benefit

Unfunded credit derivatives are considered by some to be the cause of the spread of the subprime mortgage credit crisis. But their advantages cannot be overlooked

By Chiara Oldani,
University of Viterbo
'La Tuscia'

Credit derivatives (CDs) allow risk to be transferred and repackaged. In their simplest form they provide an efficient way to replicate, in a derivative format, the credit risks that would otherwise exist in a standard cash instrument. The International Swaps and Derivatives Association (ISDA) reported in the first half of 2008 that the total nominal amount of outstanding CDs was \$54.6 trillion, a drop of 12 per cent since the end of 2007. Unfunded CDs represent

more than two-thirds of world trading. Their main advantage is that they do not expose the buyer of protection to the seller's credit risk. More than 40 per cent of global transactions take place in the city of London, and more than 90 per cent of them are not short term (see Figure 1).

Like other over-the-counter (OTC) contracts, unfunded CDs have recently been widely exploited to transfer credit risks. They are considered the cause of the spread of the subprime mortgage credit crisis (see Chiara Oldani's *Governing Global Derivatives*, published by Ashgate in 2008). The squeezing of interest rates spreads and the modified appetite for risk fuelled the

demand for innovative and lucrative securities and pushed further credit hedging. Derivatives feature the possible transfer of risk without providing complete and transparent information as well as an unclear relation between risk and return – characteristics at once dangerous and attractive.

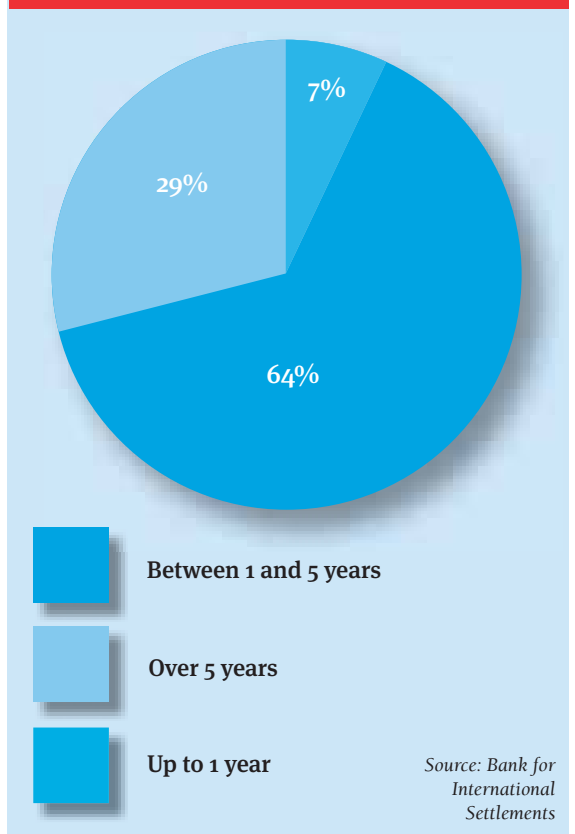
The growth and spread of CDs pose several challenges to financial markets and players. Immediate solutions are necessary for the global financial system to survive the crisis. First, the techniques for derivatives pricing must be standardised, in order to determine risk and allow more effective hedging. Second, to reduce moral hazard, there needs to be a compensation for risk (for example, by a clearinghouse). Third, regulation and supervision should be imposed at the international level, eliminating national boundaries and frictions that inevitably allow hazard and speculation to proliferate.

The pricing of derivatives relies on standard Black, Scholes and Merton hypotheses, which have been heavily criticised by scholars such as George Constantinides, Jens Carsten Jackwerth and Stylianos Perrakis. In 2007, according to the Atlanta Federal Reserve, the outsourcing of due diligence, such as by means of external credit ratings, can substantially affect the net benefit of credit default swaps, a very popular type of CD. Such actions, together with the events related to the subprime crisis, have undermined the foundations of credit rating and the originate-to-distribute model in the global financial system. Alternative pricing techniques rely on estimates of certain parameters, which cause endogeneity and bias the result, or on a simulation of parameters, based on the perfect market hypothesis, which is not in good shape.

The debate is very intense. The subprime crisis has shown that market players have dramatically underestimated counterparty risk, largely unhedged by financial and non-financial operators, rendering the global economy more fragile. As Timothy Geithner, then president of New York Federal Reserve, said in 2006: “The gaps in the infrastructure and risk management systems are most conspicuous, ... [and] ... the post-trade processing and settlement infrastructure ... is still quite weak relative to the significance of these markets.” That year, the Depository Trust and Clearing Corporation planned to establish a clearinghouse for all the contract terms and specifications of OTC derivative transactions in order to improve the post-trade cycle. This common infrastructure is vital for the survival of the derivatives market, which is drying up fast.

In his first speech as US president, Barack Obama asked for increased responsibility to “prepare the nation for a new age”. This is the recipe for the solution to the financial crisis. The secrecy and the absence of any standardisation of OTC contracts translates into financial anarchy. The necessary regulations should aim for greater market transparency of information on the types of agreement, risks involved and other relevant contractual terms. The introduction of common best practices and the collateralisation for OTC contracts are requirements that do not go against operators’ freedom or their

Figure 1: Maturity of CDSs (June 2008, notional amount million \$)



ability to create new contracts tailored to customers’ needs. But they certainly are a detriment to extra profits made by aggressive players.

Which collateral can be employed? At what percentage over the nominal value of the transaction? These are questions to be answered by regulators, and the answers can change according to the business cycle and the development of markets. In no case should it ever be a fixed percentage. Since financial globalisation has no boundaries, supervision should be a necessary condition. At the domestic level, co-ordination among the supervisors of bank, financial and non-financial institutions, stock exchanges and regulators should conform to global rules.

The challenge for the G20 leaders at London is very great. Economic conditions are deteriorating faster than expected. There needs to be deeper harmonisation in regulating financial markets at both the national and the international levels, as well as among the international supervising bodies – the Bank for International Settlements (BIS), the International Accounting Standards Board, the Financial Services Authority and the ISDA. The third pillar of the Basel II Capital Accord, on market discipline, needs to be restated in stronger terms and extended to non-financial institutions. The IMF has proven unable to cope with such risks and securities. The BIS and the ISDA both collect data and provide substantial information on transactions. The BIS and the Financial Stability Forum lack the necessary infrastructure for assuring comprehensive supervision, but they can easily fill the gap with members’ help in a reasonable amount of time. ♦



The subprime crisis has shown that market players have dramatically underestimated counterparty risk



ICE[®]: A commitment to clearing and risk management

IntercontinentalExchange[®] (ICE) is a leading operator of global commodity, equity index, credit and currency markets. ICE operates three regulated futures exchanges in Europe, the U.S. and Canada, and two over-the-counter (OTC) marketplaces. ICE also operates four regulated clearing houses. Most recently, ICE has established two new clearing houses: ICE Clear Europe[®] and ICE Trust U.S.[™]

Launched in November 2008 with \$16.5 billion in collateral and 44 member firms, ICE Clear Europe is the first new major clearing house in London in over a century. ICE Clear Europe clears contracts based on energy commodities and emissions. Launched in March 2009, ICE Trust is the leading clearing house for North American credit default swap (CDS) contracts.

What is a clearing house?

A clearing house serves as an intermediary and risk manager for exchange traded and OTC transactions. As the buyer to every seller and the seller to every buyer, a clearing house enhances market stability by requiring systematic margin and guaranty fund deposits, which serve to mitigate the impact of a potential default. Risk is pooled among all clearing house members and capital efficiencies are created through daily margining and position netting. Without central clearing, counterparties would take on the bilateral credit risk of one another. Clearing is increasingly demanded by market participants seeking ways to increase capital efficiency and enhance risk management practices.

What is the role of a clearing house?

The clearing house's primary role is to reduce the systemic risk associated with a particular market. The clearing house collects initial and variation margin deposits via daily mark-to-market pricing of contracts to ensure that the trading positions are properly valued and collateralized. In the event of a member's default, the clearing house and its guaranty fund stand between the defaulting and non-defaulting members, and the rules of the clearing house provide for an orderly unwinding of the defaulting member's positions.



What is ICE Clear Europe?

ICE Clear Europe is ICE's London-based derivatives clearing house. Regulated by the U.K. Financial Services Authority (FSA), ICE Clear Europe provides clearing services for all ICE Futures Europe[®] energy contracts and all cleared contracts transacted in ICE's OTC energy markets. Today, ICE Clear Europe clears approximately 50% of the world's crude and refined oil futures contracts. In 2009, ICE Clear Europe plans to establish a dedicated risk pool and risk management system for the European CDS market.

What is ICE Trust?

ICE Trust was formed in the U.S. as a clearing house for CDS transactions. ICE Trust has implemented comprehensive risk management systems to facilitate a transparent and capital efficient market and to reduce default risk. ICE Trust segregates cleared CDS transactions and its risk pool from other markets. ICE Trust is regulated by the Federal Reserve Bank of New York and the New York State Banking Department, and operates under a registration exemption from the SEC.

What are credit default swaps?

CDS are the most common type of credit derivative and serve a vital function in capital markets by allowing a range of market participants to hedge credit risk. In the broader financial markets, CDS provide investors and lenders an additional level of protection against credit events. CDS typically reference a specific corporate, sovereign or asset-backed bond. The CDS seller provides the buyer with credit protection on that bond. Under a typical CDS contract, a buyer of credit protection agrees to make a payment or series of payments to the seller. If the bond issuer defaults, the seller must pay the buyer the principle and interest due on the bond.

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Hedging bets

Hedge funds have been with us for decades but recent controversy has cast them in an unfavourable light

By Chris Blackhurst,
city editor, *London Evening Standard*

The very first hedge fund was created in 1949. Alfred Winslow Jones, a US financial journalist, came up with the notion of marrying traditional 'long' investing – choosing which shares will go up – with the more speculative technique of 'short-selling' – betting on shares that

are likely to go down – to 'hedge' against market risk.

To avoid having to be regulated by the Investment Company Act of 1940, he created a limited partnership of 99 investors. They entrusted him with their cash; he took 20 per cent of the profits, and charged nothing if they made a loss. So was born the hedge fund, as we know it today.

The reason it is worth recalling Jones's vision is that one could be forgiven for thinking hedge funds are a new phenomenon, spawned out of the crazy, go-go recent past. They are nothing of the sort. They have been in existence for decades – and they aroused little controversy, until now.

With the availability of credit and the surge in wealth in the last decade, the industry exploded. Today, estimates vary. But one figure reported to this year's British House of Commons Treasury Select Committee inquiry by Douglas Shaw, a senior executive from BlackRock, one of the leading operators, was 7,000 funds worldwide, holding assets of \$1.3 trillion.

With that boom has come a broadening definition, so that now any investment that pursues any

“Once impregnable corporations maintain they have been brought to their knees by hedge funds targeting their stock”



alternative strategy beyond long equities is described as a hedge fund.

And with that propulsion has come controversy. All manner of misdeeds have been laid at the hedge fund door. Once impregnable corporations maintain they have been brought to their knees by hedge funds targeting their stock; hedge funds have been held responsible for forcing mergers; the gyrations of the world markets have been blamed on their rapacious greed; and some countries even claim they have destabilised entire economies.

Because hedge funds are available only to select wealthy investors – to whom they owe confidentiality – and because they guard their techniques for competitive reasons, they have become cloaked in a shadowy mystique. Add that they do not rely on large staffs and offices but on technology, that many of them are registered in offshore tax havens and that theirs is a



sector that is largely unregulated, and they have become the focus of considerable suspicion and anger.

The clamour for them to be brought into the fold, to be treated the same as any other financial concern, has become intense. At the London gathering of G20 leaders, hedge funds are one of three items on the regulatory agenda.

That pressure, too, has come from an unlikely source. According to Shaw, some 3,000 funds have gone out of business from a peak of 10,000. Many of the remaining ones are sitting on large losses.

Hedge funds may be held liable in some quarters for the bank collapses. But they have been caught out by them as well. In some cases, clients asking for redemptions have been refused.

That is how the Madoff fraud came to light – when Bernard Madoff, controller of the \$50 billion Madoff funds, was unable to meet requests for repayment.

Ponzi scheme mastermind Bernard Madoff portrayed as the Joker from *Batman*

Madoff was a case of the hedge fund industry turning a rare light upon itself, and what was exposed was not pretty.

It revealed an industry where due diligence and controls were lax. The affair also raised serious doubts about the credibility of the so-called 'fund of funds' – managers who run a fund that invests in several funds. As an advertisement for a profession it was devastatingly bad. Anyone with cash in any fund anywhere could be forgiven for wanting it back.

Suddenly, from a position of opposing regulation and increased transparency on principle, hedge funds now realise some sort of official imprimatur could be their salvation.

In the United Kingdom, moves were already well underway to bring hedge funds to order. Having seen the damage done to the image of private equity by a political backlash, the leading players drew up a

voluntary standards code under the aegis of a report prepared by Sir Andrew Large, the former deputy chair of the Bank of England.

Its weakness is that it is non-binding and, so far, only 34 funds have signed up to the regime. Yet those are about the biggest 34 in the UK and account for 50 per cent of the country's hedge fund base.

Nevertheless, as Antonio Borges, chair of the UK's fledgling Hedge Fund Standards Board, points out, Madoff could have been prevented. "Madoff is probably the best example of why we need something like our standards," he says. "If our standards existed in the US, the Madoff fraud could not have happened, or it would have been extremely difficult to carry out. Madoff operated with complete integration of the whole activity from custody to brokerage to management to evaluation and administration. It was all under the control of one person, and that made possible the kind of fabrication of statements and mis-information that went on and prevented due diligence from discovering any kind of results. With our standards, this would not have been possible; it would not have happened."

Borges, however, may find he has to accept a much tougher framework. Before the banking failures, many governments and financial supervisors were prepared to allow the hedge funds to oversee themselves. This is still the route favoured by Todd Groome, ex-International Monetary Fund manager and the new chair of the Alternative Investment Management Association, the hedge funds trade body based in London.

His view is that hedge fund regulation was moving in an orderly, rational direction but "because of the economic climate we have now come to a point where that could unfold in a non-constructive way".

“The danger is that hedge funds would lose their precious room for manoeuvre, flexibility and freedom to operate”

Groome's worry is that some governments are seeking to be more interventionist and that they want to regulate the funds directly rather than their managers doing so. The danger there, says Groome and his colleagues, is that hedge funds would lose their precious room for manoeuvre, flexibility and freedom to operate. They would become ground down in detail and red tape.

The UK government is thought to favour a 'light touch' approach but is mindful of the shrill calls for change coming from elsewhere. At the very least, it would appear that merging the standards codes (the Alternative Investment Management Association has its own set of principles as well) and putting them on some sort of mandatory footing, to be marshalled by local financial watchdogs, looks likely. At the extreme, hedge funds may be required to accede to the same, more intense rules and scrutiny as mutual funds.

One thing is certain: the status quo is no longer an option. ♦

Traders work on the floor of the New York Stock Exchange



Curbing the effects of the crisis



EACB Chairman Piet Morland sets out how co-operative banks, as long-term oriented local retail operations, are mitigating the impact of the financial crisis

While no banking group can possibly isolate itself from the repercussions of the financial crisis, Europe's co-operative banking groups see themselves less affected. The primary purpose of a co-operative bank is to promote its members' economic interest and not to generate maximum profit for shareholders. Thus, the 4200 co-operative banks are mainly focussed on traditional retail banking and serve households and SMEs. The business model of co-operative banking has once more proven to be robust and sustainable.

Need for concerted action from the G20

The members of the European Association of Co-operative Banks (EACB) see an urgent need for concerted action between the G20 states to curb the effects of the crisis. The priorities seem clear: Stabilise the banking systems; ensure that banks continue to lend to SMEs; restore confidence among banks to return to a normal functioning of money markets, the core of the financial system; and make sure that depositors maintain their trust in banks.

Decisive action will be important. However, policymakers must in our view avoid 'regulatory activism' resulting in inappropriate and overly burdensome rules and should adhere to the principles of 'better regulation'. This requires proper analysis, consultations and impact assessments prior to passing legislation.

The focus of the IFRS accounting rules on fair value and mark-to-market has probably contributed to turning the turmoil into a crisis, as recent market developments make apparent. The result is a drying up of market segments, general lack of market liquidity and distorted prices, which do not allow users to derive 'fair' values from these markets. Thus improvements to the IFRS rules remain a matter of urgency.

Furthermore, the crisis is intensified by the pro-cyclical effects of elements of the prudential framework (Basel II). These effects will continue to have an impact during the coming months,

FACTBOX

EACB - European Association of Co-operative Banks

EACB represents one of the leading banking groups in Europe. Its membership base comprises co-operative banks from 22 European States, including Central and Eastern Countries. With 50 million members the EACB serves 160 million customers in more than 60,000 business points. Supported by 750.000 employees, EACB members hold a market share of 20% in the EU



increase capital charges and lower the lending potential of banks. Additional capital buffers will not show their effects before the next economic downturn and so will not solve today's problems.

Considering the shares of co-operative banks

When reviewing the definition of capital both within the context of IFRS (accounting) and of prudential banking supervision (Basel), the specific characteristics of shares of co-operative banks will have to be considered carefully (differing voting rights, dividends, etc.). Decisions that do not reflect these specifics could trigger excessive needs for more capital for banks that are fundamentally safe and that pass the test of the current crisis.

Strengthening of supervision

Cooperation between supervisors has to be enhanced. Colleges of supervisors should in our view unite supervisors of all authorities relevant for a group. The co-operation within colleges on an international basis will require development based on trust and the sincere intention of working closely together to achieve adequate supervision. The FSF and the Basel Committee should play an active role in promoting colleges.

Appropriate mechanisms will be required to reconcile the supervision of individual institutions with stronger macro-economical oversight.

Enhancement role IMF

The Financial Services Forum should in our view be developed into a forum for co-operation with other jurisdictions on prudential practices and regulatory standards independent from the IMF. In addition, the role of the IMF as a 'watchdog' for financial stability and macro-economical oversight should be further enhanced. Its analyses, observations and recommendations should be more focussed on reducing systemic risk and on early warning mechanisms.

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Bermuda's role in the international capital market

Economic Background

Bermuda is located in the Western Atlantic with a land mass of 53 square kilometers and a population of 62,000. From the very early days of settlement in the 17th Century, Bermuda has been engaged in some form of international economic activity. From whaling, ship-building and salt-raking during the 17th Century, to export of spring vegetables to the United States in the 19th Century, international commerce has been an enduring feature of Bermuda's economic history.

During the 20th Century, tourism was the principal source of jobs. However, during the last half of the 1990s, employment in hotels, restaurants, and other travel-related sectors declined appreciably. In contrast, employment levels in the expanding financial services and international business sectors were on a rising trend.

In the 21st Century, international business activity and the provision of business services have strengthened their positions as the leading sectors of Bermuda's economy. Bermuda's Gross Domestic Product was estimated at \$5.8 billion¹ in 2007. The two leading sectors helped to sustain an average annual growth rate of 4.8 per cent during the period 2000-2007.²

The Bermuda Tax System is consumption-based

Bermuda has a long-established and highly efficient tax system that has been in place since the 19th Century. One of the first legislated taxes, the Revenue Act 1898 that made provision for the collection of customs duty, remains in effect today.³ Other forms of indirect taxes including payroll tax, passenger taxes, and property tax, together with annual fees for international companies, generated \$813 million (or 84 per cent) of the estimated \$966 million in total revenue in 2008/09.⁴

In Bermuda, the ratio of total Government tax receipts in relation to GDP was approximately 17.8 per cent in 2007.⁵ For the United States and Canada this tax ratio was in the range of 19.5 per cent to 20.5 per cent of GDP in 2007.

The tax structure is an element of Bermuda's success, and it should be evaluated in objective economic terms. The tax system was shaped for efficiency and fairness to Bermudian taxpayers. It was not designed to attract mobile capital from other countries.

The Bermuda Monetary Authority Monetary Authority Act 1969

The Bermuda Monetary Authority (the "Authority") was established in 1969 under the Bermuda Monetary Authority Act, 1969. The Authority is responsible for the supervision, regulation, and inspection of financial institutions operating in



and from within Bermuda. The Authority also issues currency; manages exchange control transactions; assists other agencies with the detection and prevention of financial crimes and advises the Government and other public bodies on financial and monetary matters. The Bermuda Stock Exchange is regulated by the Bermuda Monetary Authority.

The Authority has developed a programme of risk based financial regulation that it applies to the supervision of banks, trust companies, investment businesses, investment funds, fund administrators, money service businesses and insurance companies which is supported by a programme of onsite supervision.

Anti-Money Laundering

Bermuda has had a long standing commitment to Knowing its Clients ("KYC") dating back over 50 years. Subsequent to World War 2, legislation was put in place requiring persons wishing to establish companies in Bermuda, to provide details on beneficial owners to the authorities. Over the years, the legislative framework in Bermuda has been updated and enhanced and currently, anyone wishing to do business in or from within Bermuda through any type of corporate structure is subjected to vetting by both the service provider and the regulatory authority, the Bermuda Monetary Authority. Further transfers of shares by non-Bermudians are also subject to review and/or control. This has resulted in a strong KYC culture within the financial services community and an emphasis on "quality" rather than "quantity".

Bermuda has legislation dealing with anti-terrorist financing and for enforcing international sanctions. In addition, there is a Memorandum of Understanding (MOU) which deals with the enforcement of UN sanctions.

The International Monetary Fund in its 2007 review noted that "the criminalization of money laundering and the financing of terrorism is generally comprehensive, with offenses applying to both natural and legal persons, and to the requisite predicate offenses."

- ¹ Bermuda dollar is pegged at par with U.S. dollar.
² National Economic Report of Bermuda 2008, Table 2 page 18.
³ Revenue Act 1898, Revised Bermuda Laws, Volume 5.
⁴ Government of Bermuda, Budget Statement 2009/10, Table II, page 25.
⁵ Total receipts includes \$929 million in taxes, licenses and fees booked to the Government Consolidated Fund plus about \$98 million of social insurance contributions that goes into the contributory Pension Fund for payment of pension and allowance to senior citizens.



In the mid 1980s, Ace Ltd and XL Capital Ltd were formed for the sole purpose of providing excess liability cover to the US market. The provision of other lines of cover such as directors' and officers' liability soon followed. In 1988 Centre Re was formed to provide the innovative structured reinsurance. These companies chose to incorporate in Bermuda because of speed to market, proximity to the New York markets and Bermuda's links to the United Kingdom.

Following the loss of capacity in the U.S. market after the 1992 Hurricane Andrew, eight property catastrophe reinsurers entered the market. In the late 1990s, Arrow Re (Goldman Sachs) and Lehman Re (Lehman Brothers) were formed to facilitate reinsurance access to capital markets. These were followed by financial guarantee companies that provide guarantees for debt securities.

Bermuda has been placed in the lowest risk category in the most recent assessment by the US State Department on vulnerabilities and threats to the US national security and the stability of the global financial system, posed by money laundering and terrorist financing.

International Cooperation: Information exchange is an area in which the Ministry of Finance has been working diligently for several years.

In the year 2000, Bermuda gave a commitment to the Organization of Economic Cooperation and Development (OECD) to uphold the standards of transparency and exchange of tax information. In making the commitment, Bermuda confirmed its longstanding position that it does not adopt or promote harmful tax measures. Further, Bermuda does not inhibit disclosure of vital tax and money-laundering information to its international partners, nor does it have bank secrecy legislation.

Bermuda participated fully in the OECD's development of a model tax information exchange agreement (TIEA) that was adopted in 2002. Bermuda's leadership role in establishing the OECD Model TIEA was assisted by its experience as a partner of the United States of America in a long-standing TIEA that was signed in 1988.

In 2003 Bermuda responded favourably to a request to negotiate a TIEA with Australia and thereafter accepted requests from New Zealand, the United Kingdom and Mexico in 2005, and from Germany, the Netherlands and the Nordic group in 2006.

In April 2009, Bermuda is scheduled to sign TIEAs with the Nordic Countries and New Zealand. A TIEA signing with Germany is pending. Therefore Bermuda will have a total of 12 signed TIEAs in 2009, with further signings anticipated in 2010.

The Bermuda Insurance Market

In the 1960s, Bermuda was a pioneering domicile for captive insurance companies. Bermuda remains the second largest domicile, after the U.S., for captive companies.

Bermuda Model

To be successful in the competitive global arena, an international financial centre must be efficient, flexible, and ready to adapt to international developments and opportunities. At the same time, it must commit the resource to provide good governance, proper regulation and effective oversight. Together these factors characterise a sound financial centre. Businesses seek to do business in a country that is sound and credible, and known internationally for probity, endurance, and market-driven solutions. Bermuda is a cardinal example of this brand.

The roster of 'blue chip' companies that have chosen to locate in Bermuda and to conduct their business under its umbrella, including those with strong links to Lloyds of London, is strong testament to the Country's reputation.

In summary, Bermuda has made a positive contribution to international tax cooperation and transparency. In addition, global financial stability has been enhanced by Bermuda's role in creating and sustaining an effective reinsurance market. The Country has aided the spread and diversification of insurance risk and the efficient allocation of capital.

Ministry of Finance
19th March, 2009



GOVERNMENT OF BERMUDA

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Illicit finance

Over the last decade, the global fight against illicit finance has focused on terrorist financing. Is the international community doing enough to counter corruption, corporate crime and the misuse of tax havens?

By Amandine Scherrer, associate researcher, Canada Research Chair in Security, Identity and Technology, University of Montreal

From money laundering through terrorist financing to tax havens, what is commonly referred to as illicit finance generally encompasses many different types of criminal behaviour and heterogeneous forms of illicit conduct. It is quite difficult to estimate the volume of unlawful transactions worldwide and to measure their impacts on financial stability. However, some aspects of the rather vague concept of illicit finance have been a high priority at the international level, whereas other conduct that harms the integrity of socioeconomic systems has been neglected by the narrow scope of international regulations.

Illicit finance and financial stability

The last decade has witnessed an increasing focus on terrorist financing. This has become an important aspect of the global fight against illicit finance within major international bodies such as the United Nations, the European Union, the Financial Action Task

Illicit finance encompasses many different types of criminal behaviour and heterogeneous forms of illicit conduct

Force (FATF) and the G8. This mobilisation has been undertaken for the purpose of preventing terrorist attacks by reducing terrorists' access to financial and other economic resources.

However, as many criminologists have suggested, it is now widely recognised that terrorists do not actually launder much money; that terrorist financing comes mostly from legitimate sources; and that relatively moderate sums are needed for terrorist actions. Therefore, the introduction of increasingly draconian legislation related to counterterrorism (such as the increasing role assigned to banks in relation to money laundering, fraud, illegal arms trading and terrorist financing) has placed a cumbersome administrative burden on banks, while playing almost no part in the prevention of terrorist attacks. As such, there remains little consensus on including terrorist funding in the global fight against illicit finance at the beginning of the 2000s, especially among financial experts. More generally, empirical evidence of a causal relationship between the effects of crime profits within the financial system and the system's monetary functioning is meagre and often contradictory.

In contrast, activities such as the proceeds of bribery and theft by government officials certainly have an impact on poverty alleviation, social development and economic growth. Even if situations of corruption may take very different forms depending on history or culture, the extent to which corruption and bribery harm economic and social development is a well-researched aspect of illicit finance. It is now widely acknowledged that this illicit conduct also affects market governance and predictability. However, attempts to harmonise international standards have encountered many obstacles, such as the question of illegally transferred funds and the return of such funds to their countries of origin.

Similarly, the question of tax havens also has a negative impact on economic growth and market predictability. The international community is far from reaching consensus here. The FATF's definition essentially targets small tax havens and exempts powerful countries such as the United States and the United Kingdom. The actions undertaken by the FATF regarding offshore financial centres have been generally perceived as ambiguous, even though there has been progress in adopting a coherent strategy. At the October 2008 meeting of the Organisation for Economic Co-operation and Development (OECD), Germany and France called on the organisation to add several countries, including Switzerland, to the blacklist of Non-Cooperative Countries and Territories (NCCTs).

Finally, corporate crime harms the stability of the financial system, which mainly relies on trust. Recent cases such as Enron and WorldCom demonstrate that fraud and corruption can involve a number of industries, leaving thousands of victims with massive financial losses. This certainly damages trust in the world of finance.

International co-operation and norms

Since the beginning of the global fight against illicit finance at the end of the 1980s, the FATF – created in 1989 at the G7 Paris Summit – has become widely

“ The proceeds of bribery and theft by government officials impact poverty alleviation, social development and economic growth ”

recognised as the international authority in the field. However, it has seldom tackled the proceeds of corruption, and has totally ignored the issue of corporate crime.

In the field of corruption, there have been significant initiatives undertaken, notably by the UN, with its 2003 Convention against Corruption (known as the Merida Convention). This convention is the most sophisticated multilateral instrument in the field. In addition, a peer pressure system on governments has been established at the recent initiative of the Council of Europe: the Group of States against Corruption (GRECO). It aims at monitoring compliance with the standards set up by the international community. Nevertheless, while the Merida Convention includes provisions against corruption in the private sector, GRECO does not address this specific issue. The international community remains relatively discreet on that matter, as compared to the loud unanimity on terrorist financing and money laundering.

Issues for the G20 London Summit

In the declaration of the G20 Summit on Financial Markets and the World Economy in Washington on 15 November 2008, the G20 leaders committed themselves to a range of medium-term actions. These included support for the FATF and the implementation of national and international measures to protect the global financial system from unco-operative and non-transparent jurisdictions that pose risks of illicit financial activity. The implementation of such measures deserves full attention and follow-up, especially the following:

- The G20 should support the promotion of a coherent strategy within the OECD on tax havens. It should also support the OECD's call at the October 2008 meeting on tax havens for an investigation into the 40 or so new tax havens in the world where undeclared revenue is hidden and where many of the non-regulated hedge funds under fire as a result of the current financial crisis are hosted;
- The G20 should promote the enhancement of international anti-corruption mechanisms, including peer-pressure systems. In particular, the G20 should support the UN's Merida Convention, as well as the GRECO initiative; and
- The G20 could play a significant role in framing an innovative international approach to fight corruption in both the public and private sectors. ♦

Government building,
Vaduz



The new way forward in global cooperation on taxes



Dr. Klaus Tschüscher, Prime Minister of Liechtenstein

According to the Declaration which the Liechtenstein Government has published on 12 March 2009, Liechtenstein commits to and will implement global standards of transparency and exchange of information as developed by the OECD and will advance its participation in international efforts, in order to address the global issue of tax fraud and tax evasion as well as double taxation. In this process, Liechtenstein will emphasize its responsibilities to address both the tax claims of other jurisdictions and the trust of its clients.

Liechtenstein is located in the heart of Europe and has always had a diversified economy with a strong industrial sector and a financial sector that has developed well and that has helped to diversify Liechtenstein's economy. Liechtenstein is a Member State of the European Economic Area and also takes part in the highly regulated European single market for financial services. Liechtenstein and its internationally integrated financial centre have a strong desire to continue to be recognised and accepted within the global community as a leading location for investment

and wealth management according to its high standards of regulation and its high quality of services.

Liechtenstein has undertaken numerous initiatives to combat illicit activities and has legislation and an administrative practice that have been evaluated positively by the FATF, the IMF, and others. Liechtenstein has ratified and implemented an agreement with the EU on the taxation of savings. Recently, it has concluded a tax agreement with the United States of America, following globally accepted OECD standards. Currently, it is in negotiations with the EU in relation to an anti-fraud agreement and is in discussions with certain OECD- and EU-Member States regarding closer cooperation in tax matters.

Due to this integration, Liechtenstein is fully aware of the challenges the current crisis poses to countries worldwide and wishes to support the efforts of the global community designed to stabilize the world economy and the financial system. As the crisis itself is global, solutions can only be found on a global level. For Liechtenstein, being a small country that is internationally integrated, the necessity of cooperation and joint action in the current situation is evident.

Vaduz Castle



Liechtenstein is committed to act as a responsible member of the global community and has expressed its willingness to further advance its cooperation in tax matters by announcing its commitment to the OECD standards of transparency and exchange of information on 12 March 2009. Liechtenstein has indicated its readiness to enter into bilateral agreements that provide also for an effective exchange of information in tax matters and intends to have a network of such arrangements in place as soon as reasonably possible in order to address the global issue of tax fraud and tax evasion as well as double taxation.

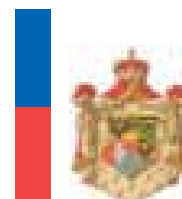
However, Liechtenstein believes that there is more we can do to address the needs of governments to ensure that their residents and, where appropriate, citizens meet their taxpaying obligations. Having the legitimate needs of its clients and its industrial sector in mind, Liechtenstein is therefore prepared to negotiate bilateral tax agreements that may go beyond OECD standards and hopes to be given the opportunity to share its views as to how Liechtenstein may help countries to address their objectives more effectively. In and around those agreements, Liechtenstein hopes to find comprehensive solutions to protect the legitimate tax claims of other jurisdictions and establish joint procedures designed to help investors, if necessary, to regularise any former, ongoing, and future tax compliance obligations in their respective countries of residence.

In order to ensure a transition to a way of cooperation that allows for the protection and maintenance of a taxable asset base, we will seek clear and detailed guidelines and technical assistance from our treaty partners with regard to the individual application of tax laws in order to inform taxpayers and Liechtenstein's financial service providers about their obligations and to provide legal certainty to clients. Thus, the Government's objective is to strive for a balance between foreign tax claims and the legitimate needs of investors in order to encourage the financial centre's role as a tax-compliant destination and to strengthen its transparency and accountability.

We believe that this approach will not only help develop Liechtenstein's role as a tax-compliant international financial centre but will lead to sustainable tax revenues for partner countries from assets that would otherwise remain outside their jurisdictions.

As with other financial centres, Liechtenstein will continue to protect the legitimate privacy rights of its clients from around the world. To this end, the Government is ensuring that Liechtenstein maintains solid and modern bank secrecy laws, considering the growing threat of data abuse in an increasingly digitalised world. It is therefore our responsibility to look for new ways of balancing the required sharing of information between governments and states as well as our democratic duty to protect every citizen's legitimate right for privacy.

During the past months, Liechtenstein has greatly benefited from discussions with certain Governments of EU-Member States as well as government associations to better understand the needs of the global community. These discussions have been most valuable in developing our March 12th Declaration. Liechtenstein appreciates the guidance it has received and is looking forward to participating in further discussions on transparency and exchange of information. I hope that many countries will take up negotiations and that we, as a result, will be able to conclude and implement bilateral agreements quickly and move forward on this issue.



Is recovery on the horizon?

The IMF's growth projections are pessimistic. World leaders need to unite the international financial institutions and rebuild confidence in domestic economies

By Robert Fauver, former US under secretary of state for economic affairs and former G7 sherpa

World leaders face the most daunting economic challenges since the synchronised global downturn that resulted from the first oil price increase in 1973-74.

They go to London for their G20 summit needing to rebuild their citizens' confidence in the domestic and

international economies and financial institutions. They must develop a unified, co-operative and co-ordinated plan of attack that will restore fragile confidence on the part of consumers and investors. To be successful, leaders will be required to put forth consistent action plans that address the global growth recession and breakdown in global financial institutions.

In the best of times, it is difficult to attain a consensus among private sector and public sector analysts on the outlook for real growth in the global





While it is difficult enough to analyse real growth in the industrialised world, it is far more complicated to prepare projections for the developing world



economy. Forecasts typically provide a range of projections that spread some three or four percentage points from low to high – during periods when there are few, if any, real risks in the near term. Given this experience, it is not surprising that the range of forecasts for global economic growth over the next year or two is very large and confusing.

At the end of January 2009, the International Monetary Fund (IMF) published substantially revised growth projections for the world economy. This latest projection was roughly 1.75 percentage points lower than its projections published in November 2008. This represents a shockingly large downward revision in the prospects for real growth in the world economy in only two months.

And many private forecasters believe that the prospects for growth are less robust than the IMF's prediction of roughly 0.5 of 1 per cent real growth for 2009. The IMF believes that the advanced economies will likely see a negative real growth rate of nearly 2 per cent this year, rebounding to something marginally above 1 per cent in 2010.

While it is difficult enough to analyse real growth in the industrialised world, it is far more complicated to prepare projections for the developing world – either as a whole or for the major individual developing countries. The IMF, for example, expected more than 5 per cent real growth in developing countries at the time of its November 2008 projection, but expected only 3.25 per cent in its January update. This reflects an increasing uncertainty in the outlook for basic commodity prices and the growth of world trade and, hence, the global outlook for real growth.

In terms of macroeconomic policy responses in the industrialised countries, the wide range in projections is not particularly relevant. It is more important to note the recent universal downward reductions in the growth outlook. Prospects for growth have declined significantly and there is broad consensus that in 2009 the industrialised world will witness a synchronised economic downturn for the first time in decades – and that the developing world will not experience sufficiently strong growth to prevent increased unemployment. The net result is that policy makers need to focus on developing monetary and fiscal policies designed to stimulate economies in both the developed and the developing worlds. In the near term, policymakers need to make an explicit trade-off between their aim of longer-term fiscal sustainability and short-term growth stimulus. Due to the very weak – and synchronised – outlook among the industrialised countries, policymakers need to err on the side of too much rather than too little stimulus.

At their Washington DC meeting, the G20 leaders identified the relevant economic and financial policy issues in their communiqué. However, hitting the key points is not the same as making the policy adjustments to reach their shared goals. It is critical that leaders pull together a set of agreed policy commitments at their London meeting. They must move beyond shared words to shared actions.

Perhaps the weakest aspect of the current global economy centres on the lack of confidence on the part of consumers and investors. Once confidence in the

economy – and its institutions – is lost, it is extremely difficult to regain it. Governments must strengthen the level of confidence within their countries, by, among other things, sharing specific commitments to policy changes – if the leaders in London show determination and willingness to act.

Those shared commitments should be to:

- reduce external imbalances (especially large surpluses or deficits);
- provide sufficient liquidity to financial markets to assure the availability of finance; and
- create fiscal spending and tax programmes that stimulate domestic spending and the creation of new, lasting jobs.

After making such a commitment in broad terms in Washington, leaders now need to provide specific details in their London declaration to assure both markets and citizens that their policies target the problems.

While the Washington meeting set the correct tone and coverage of the issues, London must set the action plans into being. Leaders need to provide their citizens with the detailed policy stances that will rebuild confidence.

The Obama administration has moved quickly and decisively to put together an economic stimulus plan targeted at restoring growth and job creation in the domestic economy. The US Federal Reserve also seems committed to assuring there is sufficient liquidity in the financial system. However, Congress, in typical fashion, could not resist the temptation to include spending on its pet programmes, which may or may not create jobs. Excess spending will reduce the impact of the overall programme. Moreover, it will complicate the second stage of the process when governments will be required to remove their stimulus programmes to prevent excess demand and inflationary pressure in the domestic economy. It will be difficult to reduce the spending levels after the stimulus is no longer needed.

The leaders in London must eliminate any speculation that there will be some sort of new international system. Such conjecture only stifles confidence. Leaders must demonstrate a strong commitment to the existing international financial system. They need to show how they will use the existing institutions – the IMF, the World Bank, the Bank for International Settlements, the Organisation for Economic Co-operation and Development, the G8 and the G20 – to respond to the current problems. They must provide concrete examples of the changes in regulations they will support in order to prevent a recurrence of the current situation in financial markets. And they need to demonstrate, with concrete actions, how the IMF and the World Bank will provide the funds to developing countries to restructure their financial markets and design the necessary regulatory systems consistent with those already in existence in the world economy.

Unless the leaders are able to present markets with a unified plan of action, the recovery will be slow to come. Growth will likely remain negative in the industrialised countries until the second half of 2010 at the earliest. In the developing world, growth will continue to slow further, waiting for the recovery of export markets before starting to strengthen. ♦

Stepping up to the plate

Newly elected President Obama will have to set out clear goals for US trade policy, committing himself to supporting globalisation through free trade and open markets

By David Hale,
David Hale Global
Economics

“ Congress has incorporated a ‘Buy America’ provision that precludes the purchase of any materials from emerging economies

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The United States will have as profound an influence on the G20 summit in April as it had on the global economic conference of 1933, when President Franklin Roosevelt rejected proposals from the other industrialised countries to stabilise exchange rates, striking a major blow to global policy co-ordination. Barack Obama will arrive with a major fiscal stimulus programme to revive the US economy in conjunction with the Federal Reserve and strengthen its banking sector through a mixture of new capital injections and loans to private investors to purchase toxic assets from the banks.

However, Congress has incorporated in the stimulus bill a ‘Buy American’ provision that precludes the purchase of any materials from emerging economies such as China, Russia and Brazil. And Obama has not yet articulated any clear goals for US trade policy. Nor has he attempted to resolve trade issues left over from the Bush administration, such as proposed bilateral free-trade agreements with Korea, Colombia and Panama.

Obama’s fiscal programme will cost about \$800 billion. As a result of the severe recession, which crimps tax receipts, the total federal deficit for 2009 could rise to \$1.5 trillion, or 11 per cent of gross domestic product (GDP) – the highest since 1945. During the next four years, US federal debt owned by the public could rise above 70 per cent. Such large deficits will greatly curtail Obama’s freedom to implement expensive new programmes and could force unpopular tax increases.



In 1945, the US public debt peaked at more than 120 per cent of GDP. But in 1945 the US was a young country embarking upon a long post-war boom. Today the US has an aging population that will increase the cost of government-run healthcare programmes. It runs a current account deficit and relies heavily on foreign capital inflows to finance its fiscal deficit. Foreign central banks own more than half of the existing federal debt stock. The Federal Reserve has promised to intervene in order to restrain the interest rates on government debt because of the global financial crisis. But there are limits to how far it can go. If the market suddenly perceived that it was taking significant inflation risks, the dollar could collapse and cause long-term bond yields to rise sharply.

This fiscal situation means the US must recognise its dependence upon foreign creditors such as China, Japan and Saudi Arabia. Treasury Secretary Timothy Geithner’s criticism of China for currency manipulation is careless given that China is now the largest owner of US Treasury securities. The global recession is now producing the largest downturn in Chinese foreign trade since exports became an important share of GDP at 40 per cent. Exporters have laid off 20 million migrant workers during the past 12 months. The Chinese current account surplus remains large at \$440 billion because imports are contracting. But China will not revalue its currency when it is experiencing job losses greater than any other country. Instead it has begun a massive fiscal stimulus programme, equal to 14 per cent of GDP while significantly loosening its monetary policy. The US should give China credit for such dramatic fiscal action while inviting it to recycle its continuing



current account surplus into funding the massive US fiscal deficit.

The London Summit offers Obama his first opportunity to meet the leaders of China and many other developing countries. He should use it to commit himself to globalisation by supporting free trade and open markets. He should refuse to implement any of the Buy American legislation. He should pledge to complete the trade agreements left over from the Bush administration. He should commit his new trade ambassador to concluding the Doha trade round. He should ask Congress to renew the comprehensive trade negotiation authority, which expired under George Bush two years ago.

The US has a greater responsibility than other countries to pursue intelligent responses to the current global economic trauma because its financial mismanagement created today's crisis. The crisis began during the summer of 2007 when investors became alarmed about the rising default rate on \$1.3 trillion of subprime mortgage loans written during a housing boom spawned by the Federal Reserve's easy monetary policy, reckless lending by the US government-sponsored mortgage agencies and irresponsible securitisation of bad debt by Wall Street investment banks. The legacy is awesome compared to the scope of the initial problem. There has been a \$32 trillion contraction of global stock market capitalisation. The G7 countries have plunged into their most severe recession since the 1930s. The International Monetary Fund now estimates that the total losses on US property lending could exceed \$2.2 trillion, compared to an initial estimate of \$965 billion one year ago. Major US and European banks have had to turn to

Treasury Secretary Timothy Geithner's criticism of China for currency manipulation is careless, given that China is now the largest owner of US Treasury securities

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The International Monetary Fund now estimates that the total losses on US property lending could exceed \$2.2 trillion

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their governments for new equity because no private capital is available.

But this is not a crisis of capitalism. This crisis was spawned by incompetent management of the US government-sponsored mortgage lenders, not just reckless free markets. The private sector magnified the errors of the public sector through overleveraging of bad assets. The rating agencies facilitated the process by giving triple-A ratings to 64,000 structured debt products at the same time as only 12 public companies on all of the world's stock exchanges had such high ratings.

Obama must use the London Summit to stress that the US will lead in promoting a global recovery with the help of other countries. He should applaud the fiscal action plans that have been unveiled since November 2008 by China, Australia, Canada, Germany and other countries. He should use the summit to pledge further US support for completing the Doha round and promoting open global markets.

The G20 was created in 1999 to promote North-South dialogue after the Asian financial crisis. It has not played a major role in global economic policy since. George Bush convened the first ever G20 meeting for heads of government last November because of the scope of the financial crisis that followed the bankruptcy of Lehman Brothers. But he could not lead the meeting because he was already a 'lame duck' president. The G20 London Summit is ideally timed to provide the new US president with an opportunity to play a global leadership role. If Obama rises to the challenge, he can help promote recovery by instilling confidence that the United States will support both aggressive fiscal policies to stimulate growth and free trade to promote prosperity everywhere. ♦



Counting on China

China, alongside other major emerging economies, is involved directly in the global economic crisis. Restoring its liquidity would help Western economies, but is China willing to assume this role?

By Linda Yueh,
University of Oxford

China's position as a leader of the G20 – as the third largest economy in the world it is already larger than most of the G7 – is often presumed but should not be taken for granted. How it acts is affected by how it perceives its relationship to the economic crisis. Understanding

China's part in the financial crisis, therefore, helps to identify its potential role in restoring global economic growth and its willingness to take on a greater role as a stakeholder in the international system.

Excessive risk-taking by financiers and inadequate regulatory supervision are certainly to blame for the financial crisis, but global macroeconomic forces should not be overlooked as a factor. This crisis has its roots in the last recession. Since the US central bank used loose monetary policy to stave off a technical recession in 2001 after the dot.com bubble burst, low interest rates were the norm for the next seven years in developed economies, despite strong economic growth.

The mispriced risk at the heart of the US subprime mortgage crisis is a result of low interest rates and excess liquidity. Credit was cheap and plentiful, peculiar in a country with a low rate of saving, a high level of consumer debt and highly leveraged firms (see Figure 1).

Normally, a savings deficit that requires borrowing to consume increases the cost of borrowing because of the low supply of funds. Moreover, liquidity did not cause inflation, due to globalisation and the global appetite for US debt. Furthermore, the US Federal Reserve missed the signal that money was too inexpensive. The low cost of capital meant that lenders continued to seek borrowers, even subprime ones.

This strong demand for US treasuries stemmed from the trade surpluses in the Middle East, due to oil exports, and Asia, due to low-cost manufactured goods (see Figure 2). When combined with a high savings rate, large foreign exchange reserves accumulated (see Figure 3). As a result of these countries' fixed exchange rates, purchases of US treasuries were necessary despite the low American interest rate and, therefore, returns. The fixed exchange rate regimes also forestalled a quick rebalancing of the global economy. When China recently recorded trade surpluses, the renminbi should have experienced pressure to appreciate. China's exports would have been more expensive for Americans, who would then buy less, reducing both the US trade deficit and the Chinese trade surplus. This did not happen, however, because China kept its currency within a managed range. It raised reserve requirements in its banking sector to deal with large increases in liquidity. This has not

Global imbalances meant that the West, with low savings, was importing savings from Asia and the Middle East

been entirely successful, as sterilisation of the inflows was incomplete. China experienced the prospect of overheating when investment, particularly in fixed assets and construction, grew rapidly and led to the prospect of an asset bubble.

Another, perhaps even more important reason, is that the US dollar is a reserve currency. Demand for it does not fall purely on the basis of demand and supply following from trade balances and capital movements. If that were the case, the twin US budget and trade deficits would have been unsustainable long ago. Indeed, the US external deficit was a phenomenon before China's significant opening to the world economy. It is not unusual for China or other developing countries to want stability in their currencies and maintain competitiveness as they grow. Nevertheless, the global imbalances meant that the West, with low savings, was importing savings from Asia and the Middle East. The appetite for the US dollar kept liquidity high and cheap (as well as interest rates low) in America. As European banks drew increasingly on the US wholesale money market after 2000, the effects spread widely. A financial crisis followed, as financiers created ever more sophisticated instruments to sell around the world.

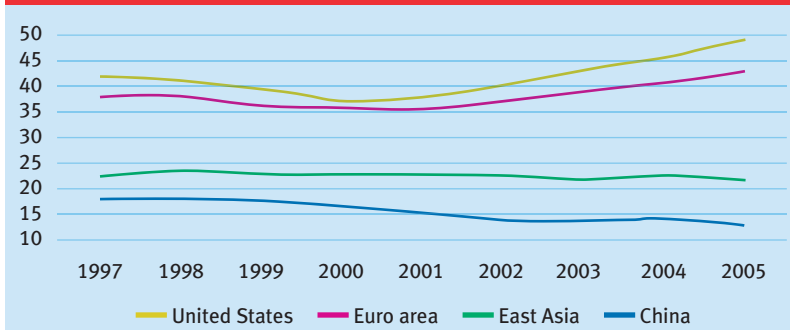
To resolve the crisis, the global economy must be rebalanced. However, this rebalancing should proceed gradually, because liquidity from China and emerging economies is needed to help the West's credit crunch. This liquidity would alleviate some of the necessary belt tightening of Western consumers. It would also help deflate the asset bubbles in emerging economies with a lot of liquidity, as well as stabilise the rich countries that provide the consumers upon whom most emerging economies depend for export growth.

Also, Western governments will have to borrow to fund the rescue packages necessary to prevent systemic banking failure. These government bonds will likely be bought by emerging economies such as China. Indeed, the demand for the US dollar rose when interest rates fell. Therefore, although global imbalances led to this crisis, they should be maintained for some time longer. Cutting off liquidity when the West is drawing upon it will probably lead to a long and painful period of austerity. But the recovery of the West and its markets is in the global interest, particularly that of China as the world's second largest trader.

Therefore, China plays a notable, albeit indirect, role in the global financial crisis. Its actions, along with those of other major emerging economies, can help to resolve it.

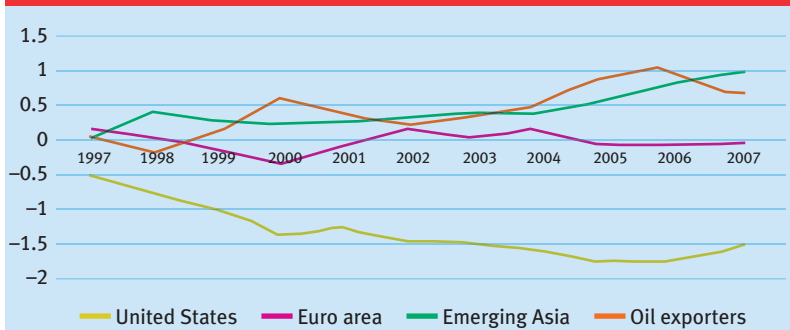
The challenge, however, is what role China, along with other surplus countries, is willing to take on. Providing liquidity is appropriate. Otherwise, easing capital flows would help finance the recovery in a way that continues to preserve the Chinese exchange rate. Allowing greater convertibility and increased flexibility of the renminbi would also be helpful, particularly as it enables China to absorb the balance of payment shocks through exchange rate movements, instead of painful real adjustments such as increased unemployment because of contracting exports. This does not necessarily mean a floating currency, but a more easily traded renminbi that allows China to navigate a middle path between stability and flexibility.

Figure 1: Gross domestic savings, percentage of gross domestic product



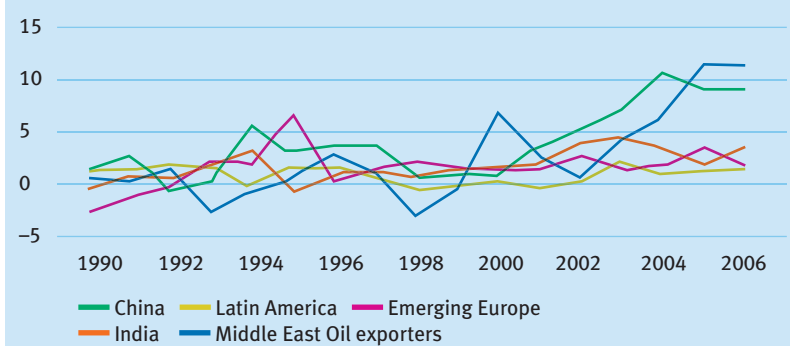
Source: World Development Indicators, World Bank.

Figure 2: Current account balance, percentage of gross domestic product



Source: World Development Indicators, World Bank.

Figure 3: Change in foreign exchange reserve, percentage of gross domestic product



Source: World Development Indicators, World Bank.



China's participation helps not only the global economy but also the country's own future



As the G20 seeks to reform the Bretton Woods institutions, China's participation helps not only the global economy but also the country's own future. The international economic system is outdated and would benefit from adapting to the changed global economic structure. It is in the interests of all countries to supervise international financial markets as well as monitor the build-up of the next global imbalance, which could next result in asset bubbles in emerging economies with devastating, widespread consequences.

No country is immune from economic crisis. China and other emerging economies could add much to the reform of the international economic system to prevent the next one. Doing so would move a long way toward the inevitable position of China as a properly vested stakeholder in the world economy. This befits one of the twin engines of growth, alongside the United States. ♦

G20 Research Group

Munk Centre for International Studies
at Trinity College in the University of Toronto

The G20 Research Group is a global network of scholars, students and professionals in the academic, research, business, non-governmental and other communities who follow the work of the G20 leaders, finance ministers and central bank governors. It is directed from the Munk Centre for International Studies at Trinity College in the University of Toronto, also the home of the G8 Research Group.

Our mission is to serve as the world's leading independent source of information and analysis on the G20. As **scholars**, we accurately describe, parsimoniously explain and reflectively interpret what the G20 and its members do, and, on this basis, responsibly predict what they will do. As **teachers and public educators**, we present to the global community and G20 governments the results of our research, ways to learn about the G20 and information about the G20. As **citizens**, we foster transparency and accountability in G20 governance, and the connection between civil society and G20 governors. And as **professionals**, we offer policy advice about G20 governance, but do not engage in advocacy for or about the G20 or the issues it might address.

The G20 Information Centre (www.g20.utoronto.ca)

The G20 Information Centre is a comprehensive permanent collection of information and analysis on the G20 available online at no charge. It complements the G8 Information Centre, which houses publicly available archives on the G7, G8 and G20.

Speakers Series

The G20 Research Group hosts a speakers series in its efforts to educate scholars and the public about the issues and agenda of the G20. Past speakers have included senior officials of the International Monetary Fund and scholars from Columbia University and the Munk Centre for International Studies.

Media Assistance

As part of its research program, whenever possible the G20 Research Group sends a field team to the summits and finance meetings of the G20 to assist the world's media on site at the international media centre and to collect the documentation uniquely available there.

Research and Publications

Among the documents and reports available on the G20 Information Centre is a document detailing the **Plans and Prospects** for the G20's agenda, updated frequently. Also available are compliance reports and performance assessments, as well as online publications such as *The G20 Leaders Summit on Financial Markets and the World Economy*, edited by John Kirton.

Working with Newsdesk Communications in the United Kingdom, the G20 Research Group has also produced a special volume commemorating the tenth anniversary of the G20, *The G20 at Ten: Growth, Innovation, Inclusion*, available online as well as in print. Plans are underway for further publications of this nature, as well as refereed research volumes in Ashgate Publishing's Global Finance Series.

A Selection of Books on the G20, G8 and Related Issues

- *The G20 at Ten: Growth, Innovation, Inclusion*, John Kirton and Madeline Koch, editors (Newsdesk)
- *The G8 System and the G20*, Peter I. Hajnal (Ashgate)
- *Governing Global Derivatives*, Chiara Oldani (Ashgate)
- *Governing Global Banking*, Duncan Wood (Ashgate)





Japan's role

Japan and the US must ensure that in seeking their own recovery, they do not ignore the needs of emerging nations

By Naoki Tanaka,
president, Centre for
International Public
Policy Studies

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Balance meant that policy expenses would be met not by new borrowing but by each year's tax revenues

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With the United States and Japanese governments facing soaring deficits, 2009 will be marked by fierce lobbying for funding in both countries. This will have a tremendous

impact on funding for other economies.

Japan's 2009 budget proposal, taken up by the Diet in February, is based on anticipated tax revenues of ¥46 trillion. That is slightly below 1987 levels.

Not so long ago, revenues were climbing. In 2007, Japan's revenues rose above ¥50 trillion for the first time since 2000. Revenues were also above that level from 1988 until 1997. In 1990, the year that Japan's bubble economy began to collapse, revenues peaked at ¥60 trillion, the only time they have reached that plateau.

While Japan's tax revenues have been set back 22 years, expenditures, which rose above ¥80 trillion in 1998, have remained there ever since. Spending cuts were made under Prime Minister Junichiro Koizumi when he took office in 2001. Government

expenditures dropped from ¥89.3 trillion in 2000 to ¥81.4 trillion in 2006. In 2006, the final year of Koizumi's leadership, the government agreed on a fiscal framework to balance the budget by 2011. Balance, in this case, meant that policy expenses would be met not by new borrowing but by each year's tax revenues. That would stem the rise in outstanding debt in relation to Japan's gross domestic product (GDP). The Koizumi plan was to create this framework and hand it over to the next leader.

It did not work out that way. From Shinzo Abe to Yasuo Fukuda to Taro Aso, none of Japan's revolving door of prime ministers has mustered enough political strength to maintain budget discipline.

Another factor was the abnormal situation that has developed in both revenues and expenditures as a result of the worldwide credit crisis. This abnormality became visible when government submitted to the Diet a proposal for ¥2 trillion in fixed grants.

Japan's fiscal reconstruction is back to where it began. The government's wish to balance the budget – before a steady stream of retiring baby boomers begins to overwhelm the pension system – will go unrealised. From here onward, Japanese citizens must re-examine the fundamental role of government under these difficult circumstances.

Japan has announced the issuance of more than ¥33 trillion in government bonds in 2009. This is an extraordinary amount, given that the government issued a total of ¥30 trillion in Japanese government bonds between 1998 and 2005. The impact of these bond issuances on capital markets cannot be underestimated: they coincide with a global credit squeeze and the likelihood that the US will issue government bonds worth more than 10 per cent of its GDP. In Japan's case, the 2009 bond issuance will easily exceed 6 per cent of GDP. The world's two largest economies are thus about to issue a record amount of bonds.

Closed economic models have always shown that increases in government bond issuances raise the risk of crowding out private spending. This time is no different.

But in both Japan and the US, while a consumer credit squeeze is a concern, a bigger worry is that developing countries may not be able to find the capital they need. Cries for help are already emanating from Eastern Europe, Latin America and various Asian countries. One special characteristic of the 21st century has been outside funds finding their way into developing economies. But as refinancing has grown difficult around the world, these economies are beginning to experience an outflow of capital.

In this treacherous fiscal landscape, the Japanese and US governments, in making sure that they secure enough capital for themselves, are pushing others out of the way. One reason is that private equity, as it grows more scarce, still considers the Japanese and US governments to be creditworthy.

The key to salvaging the world economy in 2009 lies right here. Are the Japanese and US governments prepared to rescue developing economies from a fiscal disaster? For the first time in history, the world is about to feel the side effects of the huge debt loads built up by these two countries. ♦



Redressing the balance

Major changes on the global stage will have a fundamental impact on how the current financial crisis is dealt with

By Paola Subacchi, research director, International Economics, Chatham House

By all standards, 2008 was an extraordinary year but two events stand out. The first is the financial crisis that started in mid-2007 with the subprime mortgage crisis and violently erupted a year later, in September 2008, with the bankruptcy of Lehman Brothers and the chain of bank collapses and bailouts. The second is the election of Barack

Obama as president of the United States. These two events, linked in that the former paved the way for the latter, are likely to have a fundamental impact not only on the way today's financial crisis will be dealt with, but also on the governance of the international financial system. More importantly, the crisis and the Obama-factor together have highlighted the changing dynamics of global economic power, the progressive shift to a multipolar world and the fundamentally different role played by the United States – and they will continue to do so.

A catalyst for change

The crisis is acting as a catalyst for economic governance reform, accelerating changes in the global economic order that were already under way, but at a slower pace. By dramatically rupturing the credibility of and respect for the American model, the financial meltdown and recession have put in the spotlight the ongoing shift of the world economic order. The international system, which was based on US supremacy and reflected the post-war balance of economic power, must now accommodate the rise of new powers and the relative tilt in the balance from West to East.

Even if the crisis has badly hit China and other emerging economies, showing how much their growth still depends on demand from developed countries, in particular the US, the power and influence they gained



Traders on the floor of the New York Stock Exchange watch the economic stimulus bill signing ceremony, February 2009

in recent years have turned them into key stakeholders in the debate on the new paradigm and model of economic growth.

That changes in the global economic order should be reflected in governance is now a well-accepted principle. This principle is evident in the mandate given to the G20 for the reform of the global financial architecture. And signals coming from Obama seem to indicate that the new US administration is willing to embrace the principles of inclusion and enlargement.

The reform of the international financial institutions seems high on Obama's agenda, although it is not clear whether the recognition of the US as a responsible power will stretch to a rebalancing of its power in institutions such as the International Monetary Fund. What seems clear, though, is that the Obama administration has shown little appetite for the grand reform of the international monetary system and the exchange rate mechanism – the new Bretton Woods system that French president Nicolas Sarkozy called for in November 2008, at the first G20 summit in Washington.

Still relevant

The US's financial straitjacket and loss of 'moral authority' – neither a direct consequence of the crisis but both exacerbated by it – will inevitably have an impact on its role in world affairs. The US will remain at the helm of the international economic and monetary



Signals coming from Obama indicate that the new US administration is willing to embrace the principles of inclusion and enlargement



system for some years to come – thanks, in particular, to the dominance of the dollar. However, it will no longer be a superpower, but rather a *primus inter pares*. In this role it will have the responsibility to engage developed and developing countries in the governance of the world economy and will continue to play a pivotal role in shaping the agenda of international forums such as the G8 and the G20.

One lesson from the crisis is that more players should be involved in any dialogue on the reform of the international financial architecture – particularly China and oil-exporting countries because of their large foreign exchange reserves. This dialogue must focus on the still unresolved imbalance, in some economies, between the ability to generate surplus and the capacity to absorb it, and on how to use such surplus to support rather than destabilise the global economy.

Global markets versus nation-states

The financial crisis has put new issues on the agenda, such as the need for a deep rethinking of globalisation and market integration. Why and how have markets failed at both the national and global levels? The crisis has helped highlight the intrinsic contradiction between global markets and nation-states. It has also stressed the need to reconsider the model of economic growth that has been dominant for so many years, and perhaps to replace it with one that balances consumption and production better between regions and countries – and even between sectors.

The picture is a complex one, however, with several issues that should not be bundled together. For instance, short-term concerns, which require short-term measures, should be kept separate from long-term, structural issues. Similarly, domestic issues should be dealt with by national authorities, with the understanding, however, that in an integrated world economy measures devised for the national market often have effects far beyond national borders. In a multipolar world, where economic power is more diffuse, but less effective, and where the global market overarches nation-states, the governance of the world economy is increasingly a matter of multilateral co-ordination. Economic and financial imbalances, and the underlying growth model, must therefore be addressed in international forums such as the G20.

Even if developing countries feel unable to co-ordinate with developed countries' fiscal and monetary policies and exchange rate management, to restore global growth and promote financial stability – and in this sense China's attitude speaks volumes – such difficulties should not restrain them from engaging in a broad discussion of policy lessons from the crisis and of the principles on which the new financial architecture should be based. Rethinking principles and norms is possibly the best contribution that these countries can offer while working on a new consensus on rules. Although difficult, this would be preferable to the other two potential directions as the crisis deepens. One is the proliferation of committees and forums. The other is a move toward deeper regionalism, especially in East Asia, with the creation of different standards and rules and a duplication of new organisations and bodies. ♦



Gold and the risk-return balance

There are very few among the guardians of our national finances to have previously witnessed the economic health and prosperity of countries across the globe in such a fragile state. As corporations collapse and financial systems come under severe pressure, what options should central bankers and policy makers consider as they seek solutions to restore balance, limit risk and protect wealth?

Short term government efforts to address the current crisis have focused on interest rate cuts and quantitative easing. Even if these measures are effective, they bring with them well-documented risks to the long term health of a nation's finances. Although the main concern in the short term is deflation, there is broad consensus that the risk of future inflation has been heightened by the stimulus packages and, in this regard, gold and its ability to hedge against inflation has acquired a new prominence.

Whilst gold is acknowledged for its ability to retain value and purchasing power, it is fair to say that, with the exception of the central banks and supra-national institutions that have

had substantial gold holdings for generations, there has until recently been a lack of awareness of gold's characteristics and profile as a financial asset. Even among some central bankers, gold is occasionally perceived as a legacy from a bygone age. For almost a decade however, this trend has been reversing, with growing and sustained demand for gold as an investment vehicle, and a corresponding increase in knowledge of its ability to reduce risk and add balance to investment holdings.

Septics have claimed that the gold price, as the traditional 'safe haven' and 'asset of last resort', has not performed well. On the contrary, gold has outperformed both traditional and competing alternative assets throughout the crisis and has also reasserted its virtues as a means of diversification. While shares on the global stock markets lost over US\$14 trillion during 2008, the gold price remained strong and demand for gold soared. Indeed, gold's relative out-performance was one of the factors that eventually resulted in a fall in the gold price at the end of 2008 - as it was one of the few assets remaining that could be sold at a reasonable price to meet margin calls on other, worse-performing assets. What is more, the current

WORLD GOLD COUNCIL



Aram Shishmanian is CEO of the World Gold Council. He has over 30 years experience as a management consultant working with many of the leading financial institutions operating at board and senior executive levels and has extensive international experience.

upward trend of the gold price is not indicative of a bubble, as some have suggested. It follows a sustained rise since the start of the decade, with a CAGR (Compound Annual Growth Rate) in US\$ value of around 14%, built on strong market fundamentals.

While a number of investors have made impressive returns from gold over recent years, the real value of gold is not that it provides a quick, speculative fix, but its capacity to provide a sure and steady means of protecting wealth. The current market turmoil has led many to reappraise the risk-return balance of their investments, having learnt that the unfettered pursuit of returns and neglect of risk management have contributed to the current malaise.

A key characteristic of gold is its lack of correlation with other mainstream assets, therefore rendering it an effective diversifier in a portfolio. For example, on average, the correlation between gold and equities tends to oscillate around zero. This is because the unique nature of gold market fundamentals means the gold price is moved by a different set of drivers than most key assets, even most other commodities.

The diversity of gold demand, both geographical and sectoral, is a key factor in its independence from general market trends and lack of correlations with other assets. Typically, around two thirds of global gold demand comes from the jewellery market and discretionary spending, unlike most other commodities which are reliant on industrial demand and heavily tied to economic cycles and consumption patterns in the developed world.

On the supply side, mine production has remained relatively flat for many years. Gold mining is an extremely lengthy and complex process. Long lead times to production mean the supply-side cannot easily respond to exploit an ascendant gold price. Unlike several other key commodities, such as oil, supply is also spread across the globe negating the impact of geopolitical risk and consequent supply shocks. During price spikes gold is recycled in the form of scrap (from jewellery and industrial applications) which reduces the impact of supply shortages on price.

This diversity of sources of both supply and demand underpin gold's independence, causing it to react differently to events and conditions which are influential - and potentially damaging - to mainstream assets, thereby offering protection from market falls. In other words, the diversification benefits of gold are maintained and may even increase in periods of severe market distress.

Volatility remains a pressing concern for all investors, heightened by recent market chaos. Many are surprised to learn that, over the long term, gold is less volatile than most blue chip equity indexes, such as the S&P 500. Since 1984, the average monthly volatility of gold has been around 13.7%, compared to 15.3% for the S&P 500, one of the world's most liquid stock market indices. And looking at more recent movements, with raised levels of volatility across a range of asset classes, gold has maintained its relative stability, with far lower volatility than other commodities, and being generally less volatile than most stock markets.

No one can know exactly what the future of the global economy looks like, however we can be sure that risk managed investment and wealth protection will be firmly back on the long-term agenda. With studies suggesting that an optimal allocation to gold does not necessarily require a major shift in investment strategy or portfolio composition, and a small allocation to gold can improve stability of returns when combined with more conventional assets, gold's relevance to contemporary investment strategies cannot be disputed.

Finding consensus

International policy co-ordination should not focus solely on policy enforcement. The G20 is ideally placed to emphasise the need for a shared diagnosis and co-ordinated remedies

By Jean-Philippe Cotis, director general, Institut National de la Statistique et des Études Économiques

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Mitigating recessionary forces of such a magnitude requires hard thinking

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History shows us that banking and housing crises often result in protracted economic slowdowns. This time around, with large and small economies decelerating fast and almost perfectly synchronised, policymakers face a daunting challenge. Mitigating recessionary forces of such a magnitude requires hard thinking and could certainly benefit from improved policy co-ordination worldwide. Better multilateral co-ordination may materialise in various ways, however. It may either focus on shared principles and strategies or venture further into detailed agreements about policy scope, contents and control procedures.

Tight international co-ordination may be especially useful when risks of wrongdoing or shirking are looming in the policy arena. Protectionism as well as ‘exchange rate mercantilism’ are good examples of wrongdoing that needs to be firmly contained. Shirking represents a different type of pathology that results when a country that is benefiting from positive policy spillovers from partner countries fails to reciprocate at home. It may be tempting, for instance, to abstain from expansionary domestic policies if partner countries are already heavily engaged in such an exercise.



However, the case for macroeconomic shirking looks very weak nowadays, except perhaps for small open economies. By its sheer magnitude, the current recession makes it compulsory for most countries to engage in stabilisation policies. At the national level, public opinion would not accept macroeconomic policy inaction. With economic developments highly synchronised around the world, these badly needed stabilisation policies also become much easier to co-ordinate. Similar ills, arising almost simultaneously throughout the world, should indeed call for broadly similar and concomitant remedies.

With the rationale for policy action already so strong at the individual country level, international policy co-ordination should not be overly focused on policy enforcement. Rather, emphasis should be given to shared diagnosis and policy prescriptions. The G20 is an ideal forum for such discussions.

Beyond discretionary policies, economies already benefit from a large element of automatic stabilisation in the form of falling commodity prices and inflation rates. Indeed, falling inflation is supporting household purchasing power worldwide, in a context where job losses have severe consequences on real incomes. On the fiscal side, automatic stabilisers, in the form of lower tax revenues and higher social transfers, also play a strong and timely role in supporting incomes.



Such automatic stabilisation has, nonetheless, failed to materialise thus far on the financial and monetary sides: market interest rates did not moderate until recently in reaction to the economic slowdown, while the availability of credit was brutally curtailed in the context of the ongoing crisis. Large-scale, unconventional financial and monetary policies have played a useful role in mitigating the consequences of the credit crunch. But much more needs to be done to restore the credit channels and the effectiveness of monetary policy worldwide.

With monetary and financial channels largely impaired, much of the action must now rest on coordinating discretionary fiscal policies. In normal times, it is generally felt that discretionary fiscal policy is too much of a blunt and unwieldy instrument to stabilise economic activity effectively. It may also be prone to 'political capture'. As a result, discretionary fiscal policies very often tend to exacerbate business cycles, especially during economic upswings, when governments take advantage of softer budgetary constraints to indulge in politically expedient but ill-judged tax cuts that magnify overheating.

More generally, long fiscal lags make it difficult to smooth out economic fluctuations. In an ordinary climate, it is up to monetary policy to stabilise inflation and economic activity through forward-looking and progressive policy-rate moves.

Prime minister Gordon Brown and business secretary Peter Mandelson meet business and enterprise leaders from G20 countries at Downing Street, 18 March 2009

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Fiscal policy limitations as a tool for economic stabilisation may become less of an issue under present circumstances

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In present circumstances, however, this 'ordinary climate' policy mix is unworkable. Monetary policy rates have already reached extremely low levels, and financial and monetary policies are now playing defence, emphasising the avoidance of financial meltdown and the restoration of transmission channels. Their contribution to jump-starting economic activity is thus bound to remain modest, although there will be no lasting recovery without financial normalisation.

Conversely, fiscal policy limitations as a tool for economic stabilisation may become less of an issue under present circumstances. If economic activity is indeed at risk of weakening over the next 18 months, it may not matter any more that fiscal policy acts with relatively long lags. What will mostly matter is its policy impact in 2010.

Although fiscal policy usually features high on the agenda during severe economic downturns, caution and selectivity in the choice of fiscal instruments are still warranted. Cost-effective and flexible fiscal policies are still needed – all the more so when public finances are already unsustainable in healthier economic climates.

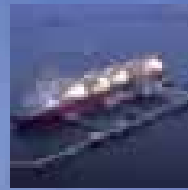
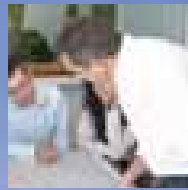
When selecting fiscal instruments, policymakers should thus privilege ease of reversibility and 'economic bang for the buck'. However, maximising economic impact and flexibility in the conduct of fiscal policy remains an uphill struggle. Policies should strive for effectiveness and the ruthless elimination of non-starters. For example, in a context where households' propensity to save is very high, across-the-board reductions in income taxes may be needed less than cost-effective public works or targeted tax rebates for households with a low income and a high propensity to consume. As well, cutting down indirect taxation or value-added taxes may not be necessary when the 'inflation tax' is already steeply falling thanks to collapsing commodity prices.

In some countries, it may be felt that such effective fiscal instruments are not present on a sufficiently large scale to cope with protracted economic slowdowns. Policymakers may, therefore, face a difficult dilemma where fighting off highly persistent shortfalls in economic activity runs the risk of locking in poor-quality public spending, as well as unhealthy deficits. To make matters worse, these trade-offs would have to be faced in a context of quite uncertain economic forecasts for 2010, making policy calibration all the more difficult.

In such circumstances, countries where fiscal sustainability problems already strongly prevail should favour targeted, cost-effective fiscal plans over all-encompassing ones. A measure of fiscal prudence may be all the more warranted since high-debt countries are often endowed with large public sectors and benefit from ample automatic stabilisers that allow them to rely less on discretionary fiscal stimulus.

Conversely, in countries with sound fiscal starting points or obvious shortages in public spending and investment, bold fiscal plans should feature high on the policy agenda. ♦

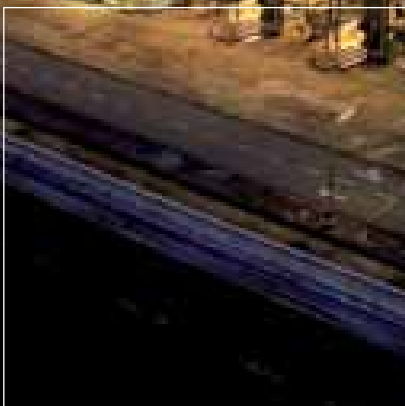
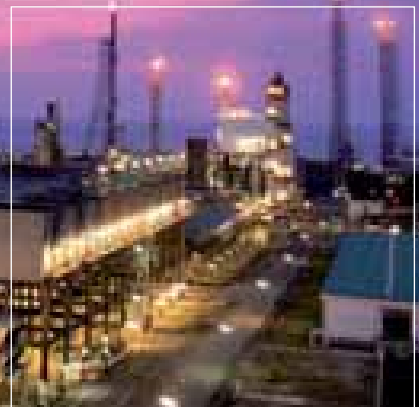
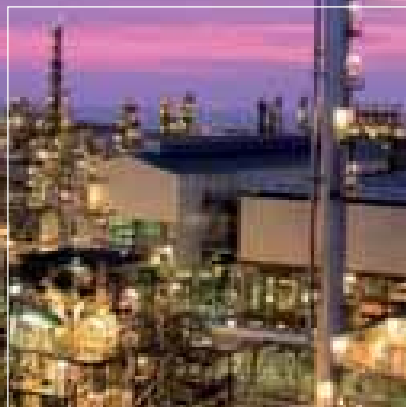
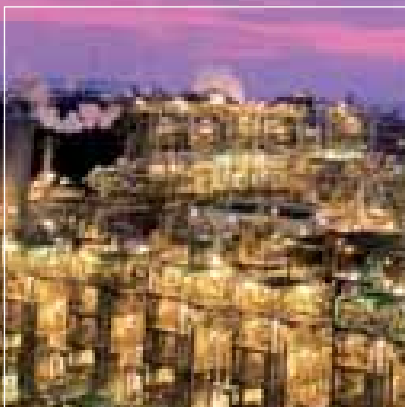
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Reykjanesvirkjun geothermal power plant: climate change is one of the most critical – even existential – issues currently confronting the global community



The climate-economy connection

There is a need for world leaders to identify, compare and share the most genuinely green employment-creating projects, and adapt production and consumption to help bring a carbon-friendly future to life

By John Kirton,
director, G20
Research Group

UK prime minister Gordon Brown has commendably added climate change to the already crowded and challenging agenda of the summit he will host in London on 2 April 2009. This is one of the most critical – one might even say existential – issues currently confronting the global community. There is deep doubt that, amid the current global economic crisis, the United Nations environment ministers' process can, by itself, meet

its December 2009 deadline to define a badly needed new climate change regime to replace the failed Kyoto one.

The G20 already has a respectable record of dealing with climate change, through its finance ministers and central bankers, and their leaders' recognition of its importance at their first summit in Washington in November 2008. Climate change is closely connected to all items on the London Summit's core agenda, including macroeconomic stimulus and financial regulation, as well as international institutional reform, development, trade and jobs. The challenge for Brown and his colleagues is to construct and catalyse the

“The G20 could construct a list of climate-friendly, employment-creating goods and services to be traded freely among G20 members”

comprehensive, coherent approach that the climate and economic crises should call forth.

In doing so, they can take inspiration from the 1979 G7 Summit, where the leaders presciently and boldly agreed to stabilise atmospheric concentrations of carbon dioxide at 1979 levels, and faithfully reduced their countries' emissions for the following five years. Then, as now, they benefited from the recessionary plunge in overall economic activity. But they wisely added a broad array of specific measures, targeting critical sectors, to get the job done.

For today's G20 leaders, fiscal stimulus is the first instrument to be used. Led by South Korea's Lee Myung-bak, many have devoted part of their recent stimulus packages and even regular budgets to well-known green investments, such as insulating buildings, expanding rail transit and low-carbon vehicles and fuels, subsidising clean energy production and use, and scrapping old cars. But these moves remain a modest minority of the new money, which is heavily skewed toward building the roads and bridges that lock in the carbon-intensive economies and lifestyles of old. There is therefore a need for the London leaders, under a strategic framework, to identify, compare and share the most genuinely green employment-creating projects, set a target of at least 20 per cent of their stimulus for truly green investments, and expand and co-ordinate their investments in them, in part to foster the global scale of production and consumption to help bring a carbon-friendly future to life. Here they should strongly endorse the tried and tested, virtually carbon-free energy source of nuclear power. It is badly needed to stop the old reliance on and new rush to coal, and is a source that is used or approved by essentially all of the established and emerging G8 countries.

To help meet their admirable commitment to longer-term fiscal sustainability, the G20 leaders could usefully craft the outlines of an international, intercontinental 'cap and trade' system to assist. As they ponder the successful precedent of Asian governments purchasing plunging equities at bargain prices, they could also consider direct intervention in existing carbon-trading markets to buy, at today's low prices, the credits that will certainly be needed, and that could be auctioned off at a profit in future years. They could even consider a carbon tax that, while preserving much of the welcome stimulus from today's plunging oil and other fuels, would counter the deadly historic re-carbonisation of the world's energy supply now underway and give governments a guaranteed source of new revenue over the longer term.

Monetary policy should also be mobilised. With central bankers now deciding which asset classes to remove from the balance sheets of beleaguered commercial banks, the G20 could privilege at the margins the particular kinds of housing, automotive and commercial loans that best contribute to the carbon-control cause.

Revising financial regulation should similarly be done with climate change in mind. In their rush to clamp down on hedge funds, private equity and venture capital, the G20 leaders should exempt these vital but now contracting sources of financing for the future green economy, to ensure that the supply of innovation will be there to meet the new demand. Afflicted credit rating agencies could benefit from the new lines of business that could be created by providing sustainability ratings, if required by government regulation.

Rules for mortgage lending should take greater account of the long-term cost to the consumer and other stakeholders of financing palatial estates in the distant suburbs and the fuel, cars, road maintenance and other services they forever need. New regulations for the insurance industry should fully consider whether the next AIG can pass the relevant stress test when the claims from the next Hurricane Katrina or Rita come flooding in, and whether the actuarial models that worked well in the past will do so in a world of intensifying extreme weather events – and potentially abrupt climate change. Subprime mortgages were not the problem the housing market faced in New Orleans in 2005.

The reform of international financial institutions can help too. It was good that the International Monetary Fund and World Bank, at the urging of the G8 in 2005, mounted a multilateral debt relief initiative to ease the debt of the poorest countries, on condition that the freed-up funds be invested in education and health. As these bodies and their regional colleagues move into massive new lending, climate change control should be added to the list. And as new money is raised to combat the financial crisis, the sums required to comply with the climate change requirements of the summits of the G8 and the Major Economies Meetings on Energy Security and Climate Change should not be left behind.

The London trade commitments should similarly be crafted with climate change control in mind. The G20 could construct a list of climate-friendly, employment-creating goods and services to be traded freely among G20 members right away. It also makes no economic sense for G20 partners to impose tariffs, new or old, on genuinely green biofuels and other products their private sectors wish to trade. It is especially costly to use national governments' bailout money to support the production and purchase of whatever cars are made at home, when better, cheaper, more climate-friendly ones can be purchased by cost-conscious consumers from abroad.

At London, the G20 leaders will have little time to do much to forge the climate-economic connection in such a close and comprehensive way. But they should create a vision, a framework and a process to make the intended global New Deal a genuinely green one. ♦



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Keeping trade open

The pressure to reach for protectionist measures in a weak economic climate must be resisted at all costs

By Peter Mandelson, UK secretary of state for business, enterprise and regulatory reform

The April meeting of the G20 will convene at a time of acute global economic strain. What began as a surge in foreclosures on the mortgage market and a liquidity crisis in the United States has rapidly spread to affect the real economies of Europe, and from there around the world. The result is the biggest economic shock since the Great Depression. For developed countries and the emerging economies alike, this is the first major economic crisis of the global age.

The chief challenge for the G20 is to preserve the openness of the global economy itself in the face of intense pressure. The World Bank has recently warned that it expects world trade growth to go into reverse in 2009 for the first time since 1982. If its projections are right and levels of investment from the developed to the emerging economies in 2009 drop to just half of the \$1 trillion they reached in 2007, then the global economy risks losing a huge slice of the demand that drives international trade.

These projections might seem theoretical compared to the day-to-day domestic challenges politicians face as we battle to keep our economies above water through the downturn. But – without wanting to overdo the overused point of historical reference – the lessons of the 1930s are precisely that if we allow the openness of the global economy to reverse, the recession will have devastating consequences.

The pressure to reach for trade barriers or other forms of protectionism is all too strong during a downturn. Because the World Trade Organization (WTO) has not struck a trade deal for more than a decade, many countries have room to raise the tariffs that they have lowered over the last ten years. Indeed, some have already threatened to do so. Studies suggest that a reversal of the openness of the last decade could quickly cost the global economy tens of billions of dollars. Moreover, such a reversal could trigger a spiral of protectionist measures that would be very difficult to halt. More subtle forms of protectionism behind the border are no less of a risk.

For that reason, the commitment made by G20 leaders in Washington in November 2008 not to raise new barriers to trade and investment must be



followed through. So, too, must the commitment to devote every effort to completing the WTO Doha round. Although negotiators again failed to reach a breakthrough in December, the downturn has not reduced the value of such a multilateral trade deal, but, rather, has raised it. A deal would lock in tariffs at today's levels, or lower, and provide a global boost of confidence in the openness of world markets.

Closer economic openness between the world's economies is in the long-term economic and strategic interests of everyone. G20 leaders must continue to make the case for free and fair global trade and for the progressive integration of the developing world into the world trade system. The commitments to achieve the United Nations Millennium Development Goals must be kept, as must the Aid for Trade pledges, which will help the poorest developing countries build their capacity to trade and integrate gradually into regional and global markets.

Indeed, should the political case for this kind of growing openness prevail, there remains the huge challenge of reforming global economic governance. The credit crisis has finally removed any doubt in the need for a new way of co-ordinating the governance of global finance.

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If we allow the openness of the global economy to reverse, the recession will have devastating consequences

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While the G20 summit format is still untested, it does offer the potential to renew the machinery of global financial and economic governance in a way that reflects the fundamental changes in the global order over the last two decades. By ensuring that China, India, Brazil and other emerging economies are represented, the G20 has reshaped the steering committee of the global economy in a way that is both necessary and overdue.

There is no guarantee of success in meeting the big challenges that lie ahead – as anyone who has watched the emerging and the developed economies inch painfully and slowly toward a Doha deal over the last three years knows all too well. Quantifying just what the developed world and the emerging economies can legitimately expect from each other on trade or climate change is politically risky. But no meaningful agreement on global economic governance is possible without a consensus with these new players at the table.

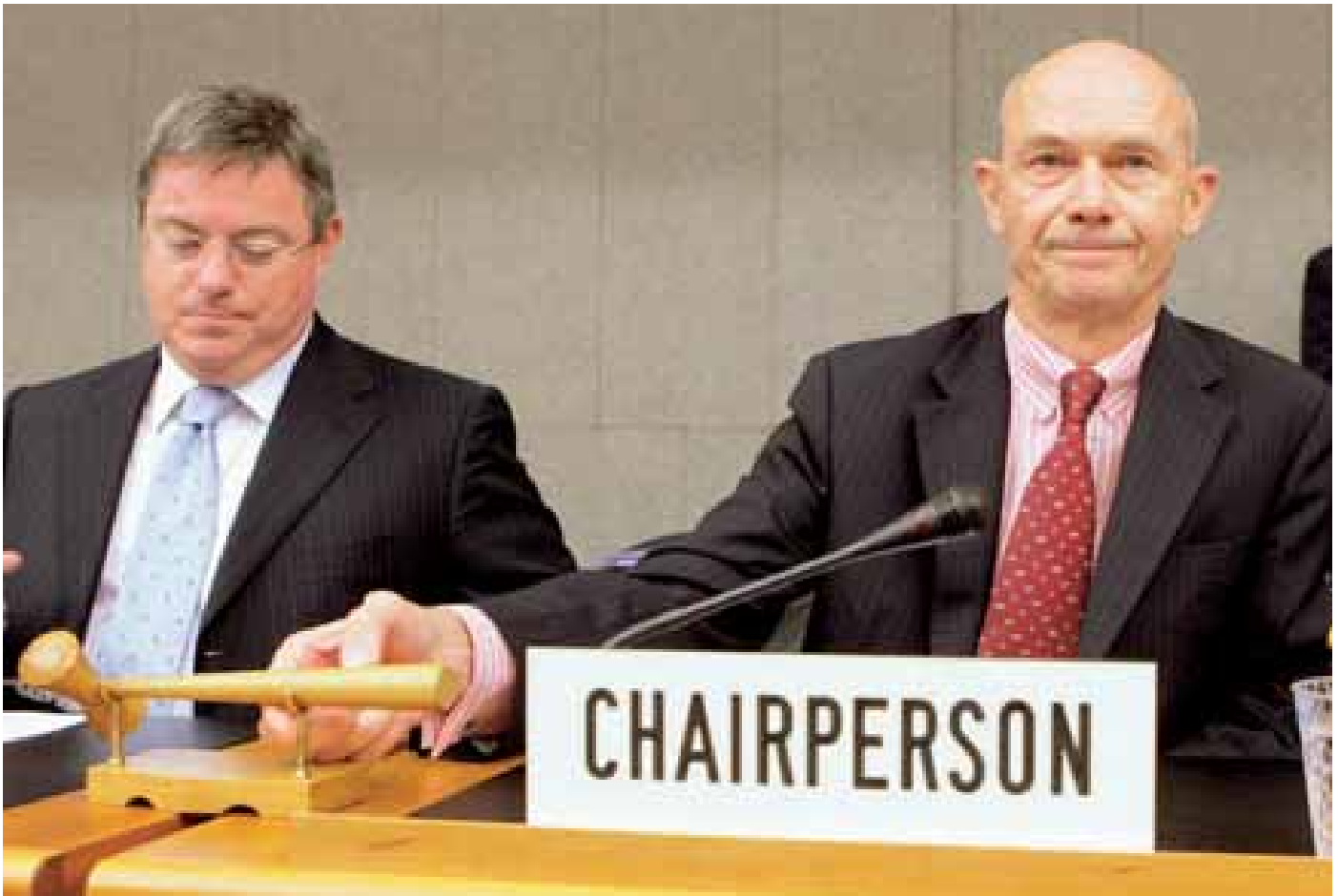
As chair of the G20 for 2009, the United Kingdom will be ambitious. At April's London Summit the UK wants to win agreement on the principles, priorities and process for global economic governance that sustains jobs, growth and stability. Open trade is at the

The pressure to reach for trade barriers or other forms of protectionism is all too strong during a downturn

heart of this. The UK will be looking for progress on agreeing reforms to bodies such as the International Monetary Fund and new forms of co-ordination to monitor global financial flows. It will also be calling for all G20 members to think internationally when they act nationally to get their economies through the downturn, not least by aiming for broad co-ordination in any fiscal stimuli.

So uppermost on the trade checklist for the G20 and the global politics of the downturn are these points: learn the lessons of economic history and, whatever the temptations, keep trade flowing and the global economy open. Keep up the pressure for a global trade deal, now more than ever. And use the current crisis as an opportunity to reinvent the machinery of global governance for a new era, just as it should be used to leverage a global shift to low-carbon technology.

Let the London Summit in April be one of those rare moments in international politics when the old gives way to the new, pragmatically and with renewed purpose. If it sounds ambitious, it is. But if we draw the opposite conclusions, especially about open trade and globalisation, we will turn a global downturn into something longer and significantly worse. ♦



Getting Doha done

G20 leaders are committed to open, multilateral trade and the completion of the Doha round. Yet there are strong, domestic pressures toward protectionism

By Peter D Sutherland, Chairman BP plc; former director general, World Trade Organization

The leaders of the G20 countries face an extraordinary challenge in agreeing on and implementing policies in response to the financial and economic crisis. The implosion of global credit markets and the ominously sharp declines in output in many countries are testing the institutions of global, and indeed regional, governance as never before.

Naturally enough, the immediate focus among policymakers has been to maintain the integrity of the banking system, followed by monetary and fiscal measures to try to limit the impact of the downturn on output and jobs. The central role of trade and the market conditions required for the healthy functioning of our national economies must not be disregarded. If the G20 leaders are to ensure that the world avoids the kind of downward spiral in trade that turned the 1930s into an economic and political catastrophe,

they must support the global and regional multilateral institutions and the disciplines that deal with trade and competition matters. One way to do that will be to complete the Doha round of negotiations at the World Trade Organization (WTO) within the next few months. Another will be to avoid resorting to tit-for-tat trade defence measures. Yet another will be to stick to existing WTO and European Union disciplines on the use of subsidies. While these are seen as necessary to respond to the pressures on industry at a time of economic stress, they can only be applied in accordance with the multilateral rules in force.

Trade is, of course, one driver of growth and recovery. The evidence reveals that a severe downturn in world trade is under way. Demand has fallen, exchange-rate volatility has created extra risk and trade finance has dried up. The situation is particularly serious for developing countries, dependent not only on exports, such as commodities or tourism, but also on both remittances from migrants' overseas work and inward investment. Their fortunes

WTO director general Pascal Lamy, right, opens the WTO ministerial summit on trade liberalisation, July 2008

are the most closely bound up with those of the global economy.

Given the scale of the economic shock facing the world, there is some risk of a self-reinforcing decline in trade and prosperity, like that which turned the depression of the 1930s into an experience that scarred a generation, and set the terrible course of events of the mid 20th century. Even though G20 policymakers are well aware of the danger and have reaffirmed their commitment to open, multilateral trade and the completion of the Doha round, it is already clear that there are strong domestic pressures for protectionist measures. At the regional level, too, particularly in Europe, there are disquieting signs of potential disruptions to the internal market – one of the world's great economic and political successes.

Another reason for some degree of pessimism is the lack of progress made on the Doha round in the good times. There have been seven years of general statements of political support for Doha, combined with an absence of the political will to complete the negotiations. Will G20 leaders, and particularly those of the United States and India, rise to the challenge of reaching an agreement now that the stakes are so high? It is imperative that they should do so.

It is essential to reach an agreement soon. Without it, there is a danger that protectionism will undo the tariff reductions of the past decade and do more damage. Most countries apply tariffs that are much lower than the ceilings set in the last round of negotiations. Without reductions in these bound rates the real levels of tariffs may move higher. Such a reversal would undermine the stability and predictability that companies need if they are to continue to trade and to invest overseas in these difficult times. Policy uncertainty is a huge disincentive to further investment, even for a committed long-term investor such as BP. It is even more so for companies in industries with shorter planning horizons.

Furthermore, without a new multilateral trade agreement the progress that has been made in negotiations so far on agricultural reform and reduced farm protection by the US, the EU and Japan will likely evaporate. While what has been agreed may be less than some in emerging markets may have wanted, a failure of the negotiations will mean the loss of this opportunity for reform of trade in farm goods. That would harm the developing country exporters at exactly the time when they need to see progress on agricultural goods.

Another powerful reason for ensuring the successful completion of Doha is the probable impact of its failure on the multilateral trade framework, and the role of major emerging markets in the institutions of international global governance. Such a serious setback for the WTO would leave a world of bilateral trade agreements, which would fragment trade and weaken multilateralism more generally.

This, in turn, would undermine hopes of weaving major emerging powers such as China, India, Brazil and Saudi Arabia into the wider multilateral governance framework. Surely, in the face of a global crisis that has laid bare the inter-connectedness of all our countries, the importance of the multilateral framework is plain to see?



Without agreement, there is a danger that protectionism will undo the tariff reductions of the past decade and do more damage

Some specific policy measures from the G20 are needed to prevent the emergence of a catastrophic downward spiral in trade. There must be sustained action to provide trade finance, given the situation in credit markets. The International Financial Corporation's trade facilitation programme has been trebled to \$3 billion, and the WTO has been monitoring the situation. But more is needed from individual governments to assist their own exporters. Some of the taxpayer funding earmarked for resolving the financial crisis needs to be directed to trade credit.

The movements in major exchange rates have been too extreme and are a source of uncertainty most detrimental to trade flows. Over time, the world needs a steady revaluation of the Chinese currency, as a reduced US balance of payments deficit and reduced Chinese surplus will be needed to rebalance the global economy. The International Monetary Fund is one natural forum for this debate. But it is arguably more appropriate for the G20 leaders to tackle this sensitive issue, which has been put on the agenda so quickly by US treasury secretary Timothy Geithner.

Finally, and of overwhelming importance, the G20 countries must live up to their rhetoric on the need to conclude the Doha round successfully this year. After the G20 communiqué issued at Washington in November 2008, which assigned trade ministers this task, Pascal Lamy, WTO director general, decided that there was no point in summoning the ministers to Geneva because their positions remained too far apart. The London Summit must reaffirm the commitment, and G20 governments must deliver on it in the months that follow. There will be a need for both good faith negotiation and some creativity to surmount the seemingly unbridgeable differences on substance. Achieving a successful conclusion of the trade round will be a significant test of G20 leadership. ♦

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Such a serious setback for the WTO would fragment trade and weaken multilateralism more generally

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Trade rounds and global crisis

Until recently, trade and investment were booming, but two key issues on the global trading agenda have been an abiding concern

By Sylvia Ostry, distinguished research fellow, Munk Centre for International Studies, and Alan S Alexandroff, research director, Program on Conflict Management and Negotiation, University of Toronto

If there was ever any doubt over the close, even intimate, relationship between trade and finance in the global economy, the statement issued by the G20 leaders on 15 November 2008 put that doubt to rest. That document – wide ranging and complex – tasked several national and international organisations to implement enunciated principles for the reform of financial markets and implement an initial set of specific measures, including high-priority actions to be completed by the end of March 2009.

While the leaders pressed forward on financial reform, asking their officials to deal with financial reform in the light of the global financial meltdown, they were quick to commit to an open global economy,

recognising “that these reforms will only be successful if grounded in a commitment to free-market principles, including the rule of law, respect for private property, open trade and investment, competitive markets, and efficient, effectively regulated financial systems”. They further declared it critically important to reject protectionism and not to turn inward. They committed to the following: “Within the next 12 months, we will refrain from raising new to investment or to trade in goods and services, imposing new export restrictions, or implementing World Trade Organization (WTO) inconsistent measures to stimulate exports.” And for extra emphasis on the importance of trade to global economic health and the need to avoid raising barriers to trade, they told their trade ministers to “strive to reach agreement this year on modalities that leads to a



successful conclusion to the WTO's Doha Development Agenda with an ambitious and balanced outcome".

Sounded great. But it was rather misleading. While there have been a few protectionist measures in some countries, the Doha round is comatose. But the most serious development was the 'Buy American' requirement in the United States stimulus infrastructure projects. Even if the economic nationalism of the 'Buy American' plan has now been watered down, there is no doubt that the ongoing global financial crisis will generate protectionist pressures around the world.

The Uruguay round and the creation of the WTO in 1995 were integral to the evolution of today's global trading system. After years of negotiation, the new system emerged in what Sylvia Ostry has argued was a "grand bargain" that, in reality, proved for many countries to be a "bum deal". The Uruguay Round negotiation created a completely different system from early reciprocity arrangements in the General Agreement on Tariffs and Trade (GATT). It was essentially an implicit deal: developed countries opened their markets to agriculture and labour – manufactured goods, especially textiles and clothing – in exchange for the inclusion of services, intellectual property and, to a minor degree, investment. But the implicit deal was more one-sided than anticipated. There was far less opening than expected and the reduction of restrictions on textiles and clothing was back-loaded and more than offset by the impact of China. The Uruguay round agreements required a major institutional upgrade and a significant improvement in infrastructure for most developing countries. Such changes demanded both time and money. For many developing countries these upgrades were difficult if not impossible. The need for advanced and sophisticated knowledge was essential but unavailable to many developing countries. The grand bargain proved burdensome for these developing countries with limited ability to overcome.

Indeed, the asymmetry of the trading system went well beyond the inclusion of services and intellectual property. The global trading system housed a 'knowledge trap'. The WTO (more by accident than design) is highly juridified. It has no real executive and legislative power and its research capability is very limited. This all adds to the knowledge trap, as the strong get stronger, and the weak weaker.

That asymmetry was recognised. In 2001 in Qatar, a new round of negotiations – the Doha Development

“ The shift in the balance of power from the old great powers to the new great powers has paralysed, not catalysed, the great game in trade ”

Pascal Lamy, director general of the WTO leaves Downing Street in London, January 2009



Agenda – was launched (after a spectacular failure in Seattle in 1999). Again, meeting after meeting has failed. The shift in the balance of power from the old great powers (US and Europe) to the new great powers (especially China, India and Brazil) has paralysed, not catalysed, the great game in trade.

The ongoing financial and economic crisis will not lead to a replay of the protectionism of the 1930s. But a serious erosion of the global trading system would further undermine confidence and increase uncertainty. A new project should be launched as soon as possible.

This proposal borrows an idea from the launch of the Uruguay round, when the US and Europe were at loggerheads over agriculture. A group of developing countries (led by Brazil and India) opposed the 'new issues' (services and intellectual property). So a group of middle powers prepared the ministerial declaration that launched the round of negotiations. At the core of the issue was the rule of law as a system in itself. This is the case today, with multilateralism at stake, and the shift in the balance of power challenging the rule of law.

A coalition of middle powers should launch an analysis of trade and development without delay. It could be funded from foundations or philanthropists. The research and discussion should all be available on the internet and briefings for today's great powers (the G20?) should be arranged. A representative from the coalition of least developed countries should receive financing to attend.

One very difficult problem is how to form the coalition. It should be voluntary, so that there is no linkage with WTO rules or negotiations. Countries should be free to withdraw and suggest a replacement. Indeed, since the coalition must be a reasonable size (although no larger than 30), rotation might be a good idea. The simplest way to handle this would be for the WTO's director general to appoint an ambassador for multilateralism to head the procedure for selection. Geography is crucial, of course, but so is the issue of dealing with the big, emerging markets (who is a middle power today?). Nonetheless, when there is a political will there is a policy way.

As for protectionist actions, foundations and think tanks that seek to hold countries to a no-protectionism standard should place these measures on the internet for the G20 leaders to review and discuss at London. As should the WTO's Pascal Lamy. ♦

Supporting emerging economies

Global imbalances and uneven policies mean the needs of emerging and developing economies are not being met. Reforms are required now to build confidence and aid recovery

By Ariel Buira,
Mexican Council
for International
Affairs

Following the US financial crisis, the world economy now faces the worst economic and financial crisis of the last 70 years. Moreover, since the meetings of the G20 in November 2008, the economic outlook has weakened all over the world. Each economic projection is more pessimistic than the previous one.

The 18 financial crises suffered by industrialised countries since the Second World War on average lasted two years and caused a 9 per cent decline in gross domestic product (GDP) and a 7 per cent fall in employment in those countries. In these circumstances, what should the G20 do to assist emerging markets and developing countries? First, industrialised countries should follow vigorous countercyclical policies, as agreed in principle in November 2008 but implemented unevenly since. This requires firmer fiscal policy commitments by members, if possible quantified, and a greater degree of co-ordination among them as a means to achieve greater positive impact.

Credit flows, both domestic and international, have dwindled. The restoration of credit is essential to economic recovery. The banks' rescue packages have protected the financial system from collapse, but have not been able to restore normal credit flows. The major industrial countries must re-establish a working banking system, be it through insurance of assets, bank recapitalisation or the purchase of toxic assets by a 'bad' bank. In addition, the restoration of confidence necessary to the resumption of credit will require stronger regulation of financial operations.

Emerging market countries trying to follow anti-cyclical policies are often not able or confident enough to do so. International credit flows have dried up, commodity prices have collapsed, exports have dropped sharply and revenues from workers' remittances, tourism and foreign investment have also contracted sharply.

What should the International Monetary Fund (IMF) and World Bank do to assist them and encourage countries with sound policies to undertake countercyclical policies? Seven possibilities stand out.

First, the purpose of the IMF – to foster the balanced growth of world trade, income and employment by making resources temporarily available to members –

cannot be met if it has insufficient means. The IMF's resources, as a proportion of world current account payments, have shrunk from more than 57 per cent in 1945 to merely 3 per cent today. The result is unduly restrictive programmes inconsistent with the IMF's objectives.

Second, reduced resources render the IMF unable to support member countries without a considerable hardening of conditionality – defined as a significant increase in the number of conditions. Indeed, in view of the relative decline in resources, the question is whether it is possible to avoid a hardening of conditionality. This leads to further questions: should adjustment programmes be constructed according to the level of IMF resources, however diminished? Should conditionality be determined by the availability of IMF resources even when these have diminished sharply over time?

The record shows a sharp increase in the conditionality of IMF programmes, particularly in the number of structural conditions per programme since the mid 1980s and during the 1990s. This trend was initiated with the supply-side economics fashionable under Ronald Reagan in the United States and Margaret Thatcher in the United Kingdom. The increase in conditionality, made programmes more difficult to manage and led to a decline in compliance with IMF programmes. This, in turn, resulted in fewer successful programmes and fewer disbursements of the resources allocated to them.

Therefore, to enable the IMF to fulfil its purposes, resources must be increased significantly – no less than fivefold. The increase in IMF quotas would provide an excellent occasion to revise the quota structure that continues to give a small group of industrialised countries political control of the institution.

Third, to increase the legitimacy and accountability of the IMF and thus the confidence of emerging and developing countries in the institution, the quota structure that determines its governance should be updated in order to represent the size of countries in the world economy appropriately. The quota structure, resulting from the reform exercises of the last few years, falls far short of what is required. Who can possibly justify the fact that Belgium has a substantially larger quota than India, Brazil or Mexico? Or that France, the UK and Germany have larger quotas than China?

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Industrialised countries should follow vigorous countercyclical policies, as agreed in principle in November 2008

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Revenues from workers' remittances, tourism and foreign investment have also contracted sharply

“The IMF is not a Red Cross philanthropic relief scheme, by which the rich countries come to the rescue of the poor”

Fourth, to prevent new crises the liquidity needs of emerging market countries must be met and current uncertainties reduced. Too short a maturity of liquidity support loans will make them unattractive and unused. The maturity of the IMF's newly established short-term liquidity facility should be lengthened from three to 12 months.

Fifth, in the current recession, the compensatory financing facility should be reactivated to help finance temporary losses in export revenues. It was designed to finance such shortfalls caused by reasons beyond the control of exporting countries. But because of its low conditionality, for more than two decades its use has been discouraged by industrialised countries that preferred to have developing countries submit to high conditionality programmes.

As Keynes noted, the IMF “is not a Red Cross philanthropic relief scheme, by which the rich countries come to the rescue of the poor. It is a piece of highly necessary business mechanism, which is at least as useful to the creditor as to the debtor”. Thus, after years of discussions, the long-overdue reform of the IMF should now be undertaken.

Sixth, the World Bank's governance structure should be similarly reformed. In addition, its resources should be available to finance quick disbursing investments in infrastructure, education, health and other ventures that will enhance productivity and assist economic recovery in developing country members.

Seventh, the export-import banks of developed countries should announce their willingness to finance well-designed investment programmes of developing and emerging market countries with substantial medium- and long-term credit programmes.

The current financial crisis is the result of global imbalances. The return of stability and growth requires the correction of these imbalances. A number of countries in Asia and elsewhere need to consume more, while the US and others must save more. The solution is easier if emerging market countries sustain higher levels of investment rather than export capital. But this requires a more stable, less crisis-prone international monetary system that makes financial crisis less likely and investment less risky. The IMF, the World Bank and other financial institutions could play a role in achieving this end to the benefit of development and of the world economy. In this, the G20 plays a major role. ♦



Kossuth Square,
Parliament Building,
Budapest, 29
November 2008

Finding stability

Weaknesses in the global financial architecture and key failures in the governance of the IMF must be addressed. Reform is overdue

By Malcolm D Knight, former general manager, Bank for International Settlements

The financial crisis that struck the most advanced countries in mid 2007 has engulfed the whole world. It has now metamorphosed into a steep weakening of global growth that may turn out to be the longest and most severe recession in the international economy since the Second World War. This adverse combination of an international financial crisis and a global recession has laid bare the vulnerability of the current global financial architecture. It is the reason why, following years of rather routine meetings of the G20 finance ministers and central bankers, on 14-15 November 2008, the G20 leaders met for the first time to try to guide a co-operative response of sufficient scope and vigour to address the global financial and economic crisis. When they meet for their second summit in London on 2 April, their talks will doubtless focus on two areas where fundamental reform of the global financial architecture is needed to restore and maintain financial soundness and stability.

The first major weakness lies in the recent performance of the International Monetary Fund (IMF). Despite the fact that the IMF is charged with overseeing the smooth functioning of the international monetary system, in practice it has little influence over the policies of the countries that are the largest players in the global economy, even when, as has been the case for the past eight years, their policies create unsustainable external imbalances. In particular, largely owing to weaknesses in governance that raise questions about its even-handedness, the IMF has not been able to convince the largest economies among its 185 member countries to conform to their basic obligation, under article IV of the IMF's Articles of Agreement, to "collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates". For this reason, a number of close observers take the view that the onset of the current crisis partly reflects a failure of surveillance, both because the IMF did not foresee it or find ways to avert it, and because policymakers in key countries were – in any case – unwilling to heed the IMF's advice. In turn, this weakness stems from inadequacies in the IMF's governance: advanced countries have a disproportionate say on its actions and the decisions of its Executive Board, while emerging market countries bear the brunt of the IMF's tutelage on the policies they have to implement to confront a distorted global financial and trading

system. This is widely seen as a key failure of the international monetary system. Major reforms of the IMF will thus be essential if it is to resume its integral role of overseeing the smooth functioning of the international monetary system.

A second weakness is the fact that financial regulation and supervision around the globe are highly fragmented, not only across countries but even among different financial institutions and markets within the same jurisdiction. Despite the fact that the financial marketplace is now highly integrated internationally, the structure of financial regulation and supervision has remained primarily the preserve of national regulators, with major overlaps and gaps in the authority of the various supervisory agencies. While the standard-setting committees hosted by the Bank for International Settlements (BIS) have worked to foster internationally harmonised standards of financial soundness, the continued primacy of national regulators has meant a 'balkanisation' of financial regulation that allowed international inconsistencies to aggravate competitive pressures, progressively weakening private sector financial risk management and inciting greater risk-taking during the upswing of the global credit cycle from 2002 to 2007. At their meeting on 2 April, the G20 leaders will need to acknowledge that internationally consistent financial regulation and harmonised supervision are necessary to make the new international financial system more stable and robust. This will require a fundamental reform of the global architecture of financial regulation.

To confront the first challenge, the G20 leaders will need to give impetus to two areas of IMF reform: strengthening the IMF's governance to give its advice legitimacy *vis-à-vis* all members and enhancing its role in surveillance of the macroeconomic and financial policies of all its 185 member countries, as well as the international monetary system as a whole.

Governing the IMF

The IMF's governance structure is not considered legitimate by many, or even most, of its member countries. As a group, advanced countries, including relatively small ones, are seen as exercising a disproportionate influence on the IMF's decisions, not only in the structure of its voting rights, quotas and Executive Board membership, but also in the appointment of its management and senior staff. Consequently, large countries – whether advanced or emerging – are generally able to ignore the IMF's advice, while potential borrowing countries feel they are unduly subject to it.



Observers take the view that the crisis reflects a failure of surveillance because the IMF did not foresee it or find ways to avert it



These concerns have been rendered more pressing by the fact that the IMF was, uncharacteristically, disengaged from the debate on growing economic and financial vulnerabilities during the run-up to the present crisis. It offered little concrete policy advice to countries on how to manage once the crisis broke. Therefore, to make IMF oversight of the international monetary system balanced and credible, and to support its surveillance work, the IMF's governance must be strengthened through major enhancements to voice, voting and quotas among all its member countries.

Reforms are needed in a number of elements of governance. While the most systemically important countries will always be *primus inter pares* in IMF deliberations, they must also accept the greatest responsibility to ensure that their actions do not unduly distort the international monetary and financial system. Thus, while many key decisions can still be reached by consensus within the IMF, voting rights must be adjusted to better reflect the global economic importance of each member. This will involve a change in the distribution of power and in the constituencies of countries represented by each of the 24 seats on the

“ The most systemically important countries must ensure their actions do not distort the international monetary system ”

IMF's Executive Board. Although efforts in this direction have failed dismally in the past, the current global economic crisis provides an unparalleled opportunity for re-examination with fewer preconceptions – indeed, the fact that the crisis has arisen in the most advanced countries should foster an open attitude toward fundamental IMF reform.

Recasting the IMF's surveillance role

As the legitimacy of the IMF's governance is re-established, the effectiveness of its surveillance role will also need to be enhanced and strengthened. The IMF's authority to undertake firm surveillance of each of its members is well articulated in article IV. Its disciplined staff also possesses the expertise to carry out this central mission. Nonetheless, the IMF's performance in recent years has been less than even-handed or effective. Aside from issues of governance and impartiality, surveillance has been undermined by political considerations. Whenever there has been an issue – whether poverty reduction, environmental concerns, the sustainability of health care and education – finance ministers have typically tried to foist responsibility for it onto the surveillance work of the IMF. Thus the IMF's work has been subject to ‘mandate creep’: it has been asked to do

too many things that are irrelevant to its oversight of the international monetary system and surveillance of its members' economic policies. As a complement to its work in individual countries, the process of multilateral surveillance of systemically important countries must be raised to a new level and given teeth. The key to reform in this area will be to use the credibility from strong governance reforms to initiate regular multilateral surveillance exercises of the key countries.

Achieving consistency in financial regulation

The balkanisation of financial regulation across national jurisdictions was one of the key factors that led to a race to the bottom in financial risk management and prudential oversight. The reforms to address this second weakness must be taken, not by the IMF itself, but through intensified international co-operation among central bank governors and the heads of financial supervisory agencies in overseeing the work of the expert committees – mainly hosted by the BIS – that establish internationally consistent standards of financial regulation and supervision. As foreseen by the G20 leaders, the governors and supervisors who meet regularly at the BIS must provide clear guidance to the Financial Stability Forum (FSF) to allow it to intensify its work on identifying financial vulnerabilities and on the needed regulatory initiatives and private sector actions to strengthen financial system resilience. The FSF will thus need to expand the scope of its country membership, perhaps by establishing local bodies in key geographic regions.

As the enhanced international financial soundness standards begin to take effect, the IMF's surveillance will need to be extended. For more than a decade it has reviewed many of its member countries under its Financial System Assessment Program. However, the reviews have been voluntary, and there has never been a review of the US financial system. In line with the impetus of the G20, every member should now agree to submit to regular assessments of its financial system on a schedule established by the IMF. This would allow it to assess whether individual countries were conforming to the enhanced international standards of financial stability and whether they were implementing financial system oversight consistently with other jurisdictions. In this way, the IMF, as part of its surveillance duties, would play a key role in assessing whether norms and standards of financial stability are being implemented consistently throughout the world. It could then identify financial vulnerabilities that could lead to financial turbulence and suggest further regulatory enhancements. Once financial soundness standards have been harmonised, the IMF will be able to give countries stronger assurance that adopting appropriate regulation will not put their own financial institutions at a disadvantage relative to competitors with more lax regimes. This is an appropriate additional role for the institution, since it flows directly from its mandate to undertake surveillance over each of its members, as well as multilateral surveillance of the international monetary system.



The political impetus for sustained reform must come from the top; that is, from heads of state and government

The process of reform

The leaders of advanced and emerging market countries alike must provide strong and continuing support for the fundamental principles on which reforms are based: good governance, transparency, inclusiveness, appropriate voice for all members, uniformity of treatment and the mitigation of conflicts of interest. It is a welcome sign that the G20 leaders are prepared to commit themselves to the goal of fundamental reform. But in substance and detail the reform and reorganisation of the IMF should be designed and implemented by its highest regular governance body, the International Monetary and Financial Committee (IMFC), composed of 24 finance ministers of the countries that, under a treaty formula, hold seats on the IMF's Executive Board. This is why governance reforms to make these seats better reflect the balance of power in the global economy are of such primary importance. As regards the reform of financial regulation into a coherent global system, the regular BIS meetings of central bank governors and heads of supervision should be intensified to insure that they continue to play a central role in guiding the work to establish globally consistent financial soundness standards. In this context, the circle of central bankers and financial supervisors that meets

regularly at the BIS should be widened. The FSF, with its expanded membership, should continue to be a key group that recommends high priority actions to be taken to maintain and restore the stability and resilience of the international financial system.

Clearly, it will take considerable time to design and implement these fundamental reforms of the global financial architecture. Therefore, the work must start in earnest now. In carrying forward a programme of reform there will be three elements. First, the political impetus for sustained and fundamental reform must come from the top; that is, from heads of state and government. Second, in the IMF's governance and surveillance work, the IMFC is the only body that has a legitimate treaty-based mandate to do the heavy lifting in implementing deep and comprehensive measures. Third, national financial regulators and supervisors must be prepared to cede an element of their discretion by committing to implement internationally consistent financial safety and soundness standards. With these sustained reforms it may be possible to build an international financial architecture that can be free of recurrent crises of the sort the world is currently enduring. The G20 leaders will need to give firm impetus to this process at their meeting on 2 April. If they do so, the prospects for restoring global financial stability will be greatly enhanced. ♦

IOSCO: co-ordinating the response

Liquid capital markets have a major role to play and can be a measure of the health of the global economy

By Jane Diplock,
chair, Executive
Committee,
International
Organization
of Securities
Commissions,
and chair, New
Zealand Securities
Commission

The G20 has recognised that while the regulation of financial markets is the responsibility of national regulators, financial markets are global and therefore increased co-operation among regulators is essential. It has also recognised the need to strengthen international standards and their consistent implementation in order to avoid further market deterioration and to ensure the future viability of capital markets.

The International Organization of Securities Commissions (IOSCO) believes that well-regulated and liquid capital markets play a crucial role in the global economy. They are at the heart of the recovery of the global financial system and restoring investor confidence, while facilitating the innovation and capital market development that form the basis of strong economic growth.

IOSCO is the international standard-setting body for securities regulators, with members from more than a hundred jurisdictions that regulate more than 95 per cent of the world's securities markets. Its standards are recognised as the global standards for securities market regulation.

In the interests of promoting integrity in the financial markets, regulation should be cost effective and aimed at ensuring that a sound market infrastructure exists: sufficient transparency, strong clearing and settlement processes, and robust enforcement systems targeted at market abuse.

The G20 should commit to encouraging jurisdictions to ensure their regulatory regimes comply with IOSCO's Objectives and Principles of Securities Regulation and to exhort them to become signatories to the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (MMOU). Effective implementation of such IOSCO initiatives, which foster the strengthening of international regulatory standards, their consistent



implementation and cross-border enforcement related co-operation, will require political will and financial resources. Support from G20 governments to this end will be important.

G20 recommendations and IOSCO actions

IOSCO has been addressing the effects of the financial crisis on securities markets through its technical and emerging markets committees. Several expert task forces have been established for this purpose.

Following the G20's recommendations at its Washington summit in 2008, the IOSCO Technical Committee launched three task forces to address specific G20 concerns related to market integrity. These task forces are working on urgent issues relating to short selling, unregulated financial markets and products, and unregulated financial entities. IOSCO will provide the results of its work for inclusion in the report to the G20 leaders ahead of the London Summit in April.

Since 2005, IOSCO has been working with unco-operative or under-regulated jurisdictions in terms of cross-border enforcement co-operation. It has mounted a successful initiative that involves securities regulators from those jurisdictions explaining the need for them to meet IOSCO's standards, even if they are not yet signatories to the MMOU or IOSCO members.

Through the Technical Committee, IOSCO has an ongoing dialogue with financial markets stakeholders. This provides IOSCO with clear industry views on its



Frankfurt Stock Exchange, January 2009

work and direction, so IOSCO will be able to submit well-informed views to the G20.

IOSCO welcomes its inclusion in the G20's Working Group on Enhancing Sound Regulation and Strengthening Transparency and the Working Group on Financial Market Integrity and International Co-operation. IOSCO's involvement recognises its central role in the development of international regulatory standards, and will ensure that the views of securities regulators are present at the policy formulation stage.

Responding to crisis

IOSCO's Technical Committee established the Subprime Task Force in November 2007 to review the issues facing securities regulators arising from the crisis in credit markets. This task force reported in May 2008. It outlined a programme of work targeted at addressing the failings identified in the private structured-finance market, specifically issuer transparency and investor due diligence, firm risk management and prudential supervision, and valuation.

Work on the issues associated with the activities of credit rating agencies in the structured-finance products market has resulted in amendments to IOSCO's Code of Conduct Fundamentals for Credit Rating Agencies in relation to the quality and integrity of the rating process, independence and avoidance of conflicts of interest, responsibilities to the investing public and issuers, and disclosure of the code of conduct and communications with market participants.

IOSCO favours a consistent global regulatory approach to monitoring the activities of credit rating agencies, to avoid any regulatory fragmentation. It is working toward developing mechanisms by which regulators and investors can be assured that agencies are following IOSCO's Code of Conduct and through which national regulators co-ordinate their monitoring of credit rating agencies.

The Emerging Markets Committee is also working on the effects of the financial crisis from developing and emerging capital markets. In addition to its internal work, IOSCO is an active member of the Financial Stability Forum.

Raising standards

IOSCO has long been committed to a global approach to the development of robust standards of securities regulation to ensure that global capital markets operate according to sound principles and standards, with regulators that can co-operate and exchange information across borders. IOSCO's objectives are aimed at ensuring the protection of investors; the fairness, efficiency and transparency of the markets; and the reduction of systemic risk.

These objectives are supported by IOSCO's principles, adopted in 1998, which make it possible for governments and regulators to gauge the effectiveness of their securities regulation. Indeed, these principles are recognised as the international benchmark for securities regulation. They are currently being reviewed to ensure they adequately reflect recent developments.

Tackling enforcement co-operation

The MMOU, developed in 2002, is the global information-sharing arrangement among securities regulators. An international standard for co-operation critical to combating violations of securities laws and regulations, it seeks to overcome the barrier of banking secrecy laws that prevent the exchange of essential information. IOSCO aims to have all members as full signatories or committed to removing impediments to becoming signatories to the MMOU by 2010.

Currently 49 securities regulators, from all continents and levels of development, have signed on to the MMOU, with an additional 16 IOSCO members committed to making the changes necessary to do so and 25 more members currently undergoing the assessment process to become signatories. Existing signatories use the MMOU as their mechanism of choice for enforcement co-operation. Expanded membership of the MMOU will deliver significant benefits for global capital markets as the enforcement activities of securities regulators become stronger, particularly in the current climate.

Under IOSCO's initiative of contacting unco-operative or under-regulated jurisdictions identified as problematic regarding cross-border information sharing, the organisation has commenced a detailed dialogue on the specific requirements of the MMOU with six such jurisdictions. This initiative is producing encouraging responses, including legislative and behavioural changes. In particular, one of these jurisdictions has since been able to sign onto the MMOU. ♦

Called to account

The key global accounting standards agencies should strive toward the creation of a single global standard. The need for reform is pressing

By Sir David Tweedie, chair, International Accounting Standards Board

The first and prime lesson to learn from the extraordinary global financial and economic crisis is that the answers to problems, both current and future, need to be provided by truly global bodies and organisations. This lesson will enable the G20 and the global community to cope more effectively with the challenges they face.

The G20 Summit in Washington in November 2008 made this clear. It proposed the principle that the key global accounting standard-setting bodies should work intensively toward the objective of creating a single high-quality global standard. This has been the core mission of the International Accounting Standards Board (IASB) since its inception. The IASB's rapid progress in recent years means that this goal is now within reach. Future stresses and strains on the global financial markets will be eased substantially when one single and rigorously applied accounting language is in use. Opportunities for regulatory arbitrage will be reduced. Both investors and companies will benefit from enhanced comparability and consistency.

Convergence in financial reporting is leading the way in global solutions. The IASB has been actively engaged in promoting common standards around the world and in ensuring convergence among major economies. More than 100 countries now use International Financial Reporting Standards (IFRS). All the major capital markets have adopted IFRSs, or are well advanced in converging with them.

This process predated the current global financial and economic crisis. When complete, it will provide much of the framework that will enhance understanding of the reality of companies' financial and economic positions. This, together with future regulatory mechanisms in the capital markets, should provide greater certainty and confidence for investors.

The past months have underlined the value of this approach. It is very important to ensure that there are no means by which companies can game financial reporting rules and obscure their true position by being able to use a lower-quality, less onerous standard. Doing so, as seen in arguments over the reclassification of assets, both reduces confidence in the financial information disclosed and further weakens the financial stability of the economic entities concerned.

The IASB and the US Financial Accounting Standards Board (FASB) have committed to a joint approach to enhance market confidence. Urgent action has been taken to improve guidance for the application of fair value in illiquid markets, disclosure of fair value information and transparency for off-balance-sheet assets and liabilities. Public discussions have been held in Asia, Europe and North America to gather input on other reporting issues, including responses from governments, regulators and others.

In addition, the boards have established the high-level Financial Crisis Advisory Group (FCAG) in direct response to the G20's request to further understanding of the current crisis. This group of senior leaders with broad international experience in financial markets is co-chaired by Hans Hoogervorst, chair of the Netherlands Authority for the Financial Markets, and Harvey Goldschmid, former commissioner of the US Securities and Exchange Commission. Its task is to consider how improvements in financial reporting could help enhance investor confidence in financial markets, identify the accounting issues requiring urgent and immediate attention of both the IASB and the FASB, and define issues for long-term consideration. By the time of the G20 London Summit, this group will have held three public sessions and made a preliminary report.

In the meantime, the IASB has been working on other urgent projects identified by the Washington Summit. It has issued guidance for valuation of securities, particularly the valuation of complex, illiquid products, especially during times of stress. It has published

“ IASB has issued guidance for valuation of securities, particularly the valuation of complex, illiquid products, especially during times of stress ”



The Financial Crisis Advisory Group is co-chaired by Hans Hoogervorst, chair of the Netherlands Authority for the Financial Markets

proposals to improve the information available about fair value measurements of financial instruments and liquidity risk. An exposure draft of a standard on fair value measurement will be published soon.

Standard setters have also acted on the need to bring greater transparency to previously off-balance-sheet items. They have been revising their standards dealing with derecognition of financial assets and liabilities and the consolidation of controlled entities. The IASB has also been working on weaknesses perceived in disclosure standards for off-balance-sheet vehicles. In late 2008, the IASB published an exposure draft on consolidation accounting aimed at enhancing existing rules. Proposals to improve derecognition requirements for securitisation will be published around the time of the London Summit. These projects should be complete by the end of 2009.

Significant enhancements to the governance and public accountability of the International Accounting Standards Committee Foundation, the governing body of the IASB, have also been implemented through a review that began in 2007. The establishment of a formal link to public authorities directly addresses the G20 recommendations. At its core the IASB's effort to create a single, truly global accounting language has been achieving the correct balance between independence, both of thought and structure as well as of accountability.

Underpinning the organisation's structure is the internationally accepted principle that global accounting standards should be developed by the independent IASB. The IASB reaches conclusions following a transparent and open due process that considers the views of all stakeholders. An independent and geographically diverse body of trustees oversees the IASB. The trustees are now publically accountable to a monitoring board of public authorities. This approach replicates, on an international basis, the link between accounting standard setters and those public authorities that have generally overseen accounting standard setters at the national level. While it is no substitute for the extensive engagement of the IASB and the trustees with interested parties, the monitoring board will provide significantly enhanced public accountability.

As the G20 summit in London approaches, attention among policymakers and banking supervisors has turned toward addressing financial stability, part of which relates to the issue of procyclicality. This complex area requires much consideration. The IASB is well advanced in discussions with the Basel Committee on Banking Supervision designed to ensure that efforts addressing procyclicality through changes in prudential regulation are dealt with in a way that will not harm investor confidence in financial statements. This would itself cause further financial instability. The FCAG is also addressing the issue of procyclicality, and the IASB will consider its input in an expedited fashion.

A globally consistent response on financial reporting issues is essential to the goals of the London Summit. The IASB urges the G20 to support the development of a single set of high-quality accounting standards that serve the needs of investors. Their confidence in the quality of the financial information they receive forms an important component of recovery. ♦

Global problems, global solutions

Collaboration and independence are required for high-quality accounting standards to help investors as well as the financial markets

By Robert Herz, chair, Financial Accounting Standards Board of the United States

From the perspective of an accounting standard setter, the global financial crisis has reinforced the importance of consistent, high-quality financial reporting. But it has also underscored another important truth – that global problems require global solutions.

The cascading negative effects of the weakened credit and financial markets have demonstrated the vulnerabilities of even the most resilient economies in the world. Although the credit crisis originated with the mortgage securities markets, the effects were experienced rapidly in financial markets worldwide due to increasingly globalised and interconnected capital markets and economies. It has shown how actions in one market or economy can have a severe impact on others, resulting in major dislocations nationally and internationally.

Resolving the issues underlying the crisis will be an enormous task. But there is optimism to be found in the strong international co-operation that has emerged. This co-operation has included market-led efforts such as those by the Institute for International Finance, the

Counterparty Risk Management Policy Group and the G30, as well as increasing collaboration and co-ordinated efforts by governments, central bankers and regulators through the G20, the International Organization of Securities Commissions, the Financial Stability Forum and the Basel Committee on Banking Supervision. In the area of financial reporting, there have been many joint efforts in accounting standard setting between the Financial Accounting Standards Board (FASB) in the United States and the International Accounting Standards Board (IASB). Additionally, strong actions taken by the US administration, Congress, the Federal Reserve and others are helping to demonstrate to overseas markets that the US is willing to address these issues urgently and forcefully – and in a collaborative way – and to do its part to help restore global confidence in the financial system and the capital markets.

The FASB has responded vigorously with accounting changes and enhanced disclosures needed to address emerging financial reporting issues arising from the crisis, including those relating to securitisations and off-balance-sheet entities, financial guarantee insurance, credit default swaps and other derivatives, and fair value measurements and impairments of financial assets. Moreover, consistent with the recommendations



Lawrence Smith, FASB; John White, director of the Office of Corporate Finance at the SEC; and James Kroecker, deputy chief accountant at the SEC, at the Senate Banking Subcommittee on Securities, Insurance, and Investment hearing on transparency in accounting practices, September 2008

of the G20, it is working actively with the IASB to coordinate actions and to improve and converge standards in major areas, including those relating to accounting for financial instruments. These joint standard-setting efforts have benefited from the input received at a series of global roundtables held in November and December 2008 on reporting issues relating to the financial crisis and from the ongoing discussions of the senior-level Financial Crisis Advisory Group.

Addressing reporting issues with high-quality accounting standards requires that the standard-setting process be independent and free from political interference. Both the FASB and the IASB are very concerned about recent efforts in the US and elsewhere to implement specific changes in accounting standards through political pressure or explicit legislation.

Any political actions to overturn or revise accounting standards could further undermine investor confidence and dangerously compromise the credibility of financial reporting at a time when the capital markets are under great stress and in need of greater transparency – the principal goal of standard-setting efforts. Sound, unbiased information is the oxygen of financial markets.

The role of accounting and reporting standards is to help provide investors and the capital markets with reliable, impartial financial information on the activities, results and financial conditions of reporting enterprises. Some mistake this role and confuse it with the formulation of policy to deal with the facts revealed by financial reporting.

Good accounting and reporting can have economic consequences. To deal with these consequences requires policymaking and political choices. Regulators are empowered to apply prudential rules, such as capital standards, that reflect the needs of the economy as well as the circumstances of particular businesses. Tax codes and regulatory statutes are full of subsidies, prohibitions and prudential judgements that shape economic choices by companies and individuals. Such choices are the stuff of politics and governance. But accounting standards are not to favour or disfavour particular choices. They are intended to promote transparent public reporting by companies to investors and the financial markets.

Thus, standard setters have an unyielding responsibility to ensure that they maintain their independence and objectivity in setting high-quality standards, and resist attempts at political intrusion into the processes, while always actively seeking input from constituents and maintaining accountability to the investing public.

As they tackle the complex financial challenges ahead, G20 leaders must reaffirm the importance of independent, open and thorough due process for US and international accounting standard setting that is free from political interference. In turn, the FASB commits to collaborate with its international colleagues at the IASB, with constituents and with government officials, legislators and securities and financial regulators to help forge the financial reporting improvements necessary to foster renewed health and vitality of the global capital markets.

It remains the job of governments, legislators, regulators and standard setters to carefully examine



and understand what has occurred and develop the necessary strategies to try to set the financial system on a path to renewed health, sustained growth and avoidance of the mistakes that brought on the current crisis. Market-led reforms and solutions will also be critical to ensuring the sound and effective functioning of financial and capital markets and to help avoid a repeat of recurring problems.

As all join together to solve the complex array of issues facing the financial system, they must collectively reaffirm their shared understanding that sound markets require proper infrastructures to facilitate the flow of information, ascertain price discovery, support the necessary clearing mechanisms and allow for informed and knowledgeable market participants. Effective oversight and regulation are also key ingredients of sound markets, as are the exercise of appropriate due diligence by investors and proper risk management processes by financial institutions. Building and maintaining such infrastructures and processes will be key to restoring public trust and confidence in the financial system and capital markets.

Accounting standard setters are committed to doing their part to help achieve these all-important objectives. ♦

“ The FASB and the IASB are concerned about recent efforts in the US and elsewhere to implement specific changes in accounting standards through political pressure or explicit legislation ”

Co-ordinating the response

Measures taken in advanced markets can have negative implications for emerging economies. The financial architecture must be rebuilt and a co-ordinated effort should ensure that all parties come to the table

By Erik Berglöf, chief economist, European Bank for Reconstruction and Development

The global financial crisis is wreaking havoc in the world economy. What started at the heart of the global financial system is now putting years of economic growth and decades of reforms at risk in emerging and developing economies. Governments in advanced economies have responded with ambitious programmes to support their own banking systems and seemingly ever-growing stimulus packages. These efforts are important in stabilising the global financial system and restoring international capital flows. They should also help resurrect global demand and ultimately benefit exports from emerging and developing economies.

But as the G20 leaders sit down to reconfigure the global financial architecture in London in April, they must consider how these measures in the advanced markets also have negative consequences – unintended and intended – for the rest of the world. Many emerging and developing economies do not have the resources to back up generalised guarantees to depositors or large banks, resulting in deposit outflows and financial instability. Fiscal constraints also prevent them from matching the large public consumption and investment packages. In fact, the enormous lending programmes of the advanced economies threaten to clog up public finance markets for years, effectively shutting out many emerging and developing economies.

To make things worse, political constraints may prevent support packages in advanced economies from fully realising their positive spillover effects on poorer countries. Just as there are pressures to keep aggregate demand ‘in the country’ through measures ranging from buy-local initiatives to unvarnished protectionism, there is also pressure to keep home-country liquidity support – and, even more important, capital support – from leaking out of national financial systems. As a result, national bank rescue packages often restrict banks from supporting their foreign subsidiaries.

Even if there were a financial architecture in place that would allow the positive spillovers from national

crisis packages to take effect and limit the unintended consequences of such packages, there would still be a need for co-ordination. For example, the linked fates of parent banks, their subsidiaries and host-country authorities in the subsidiary countries raise a collective action problem. Parent banks will hope for recapitalisation and financial support for subsidiaries from host governments. Host governments will hope for the same from parent banks. Without co-ordination – which necessarily must also involve the home-

“The lending programmes of advanced economies threaten to clog up public finance markets for years”

country government that supports the parent – there will be an underprovision of assistance.

The world’s leaders are right to ask what the international financial institutions, individually and jointly, can do to fill these glaring gaps in the current global architecture. After all, through their shareholder structure they internalise, more or less perfectly, the cross-country spillovers. If properly designed, these institutions should have the necessary flexibility to adjust in the crisis. Through their resources and convening power they can entice both main actors to come to the table. No matter the justification for the original creation or the current mandate of a particular institution, if it cannot make a difference in the current crisis, its very existence will be questioned.

No region is more affected by the global crisis than Central and Eastern Europe. After two decades of unprecedented economic and political reforms and resurging trade and growth, these economies are now



No region is more affected by the global crisis than Central and Eastern Europe: abandoned factory, Lodz, Poland

in the midst of a crisis that challenges many of their achievements. The capital flows that have fuelled this growth model have dwindled to a trickle, reinforcing the contraction in demand for the region's exports. Industrial production is declining almost everywhere in response to the credit squeeze and sharp drops in demand for the region's exports. The only remaining private funding source – the foreign parent banks – looks fragile and appears as a possible channel of contagion. If this vital link breaks down, the region could experience a full-blown collapse with multiple twin banking and currency crises.

The task at hand is truly daunting. The refinancing needs of the banking sector alone in the region are expected to be in the order of €200 billion. Even a modest deterioration of loan quality will require additional hundreds of billions of euros for recapitalisation. These staggering sums require contributions from many parties. Most of the resources will have to come from the international banks and their home governments, but for the release of these funds, governments in Eastern Europe must give certain assurances. The international financial institutions can help relax the political constraints on both home and host countries. They have the resources to entice private investors as well as governments to participate.

Co-ordination is also critical to avoid counterproductive unilateral actions. Nationalisation of a foreign subsidiary in one country could easily affect the banking system of another country, either through weakening of the parent bank or through runs on subsidiaries elsewhere. A decision by an international

“ EU co-ordination of crisis programmes has done little to address spillovers among new member states, let alone their impact on non-EU members ”

bank to cut its support to a subsidiary could have similar ripple effects. Unfortunately, European Union co-ordination of national crisis programmes has so far done little to address spillovers among the new member states, let alone their impact on non-EU members.

In responding to the need for action in this institutional vacuum, the European Bank for Reconstruction and Development, the International Finance Corporation and the European Investment Bank are working with the governments and international banks active in the region to create a mechanism for regional co-ordination with the working title of the Vienna Initiative. Its meetings bring all the relevant parties to the table. Home and host countries first met in Vienna in January 2009 to ensure a more efficient flow of information and encourage steps toward fair burden sharing. Since then, meetings in several host countries have encouraged co-ordination between domestic banks and foreign subsidiaries on the one hand and the governments on the other. The international financial institutions play a facilitating role in these discussions. They also invest in the parent banks and their subsidiaries.

Co-ordination failures have traditionally been a major obstacle for global development. The Vienna Initiative highlights the important role of the international financial institution in bringing about co-ordination. The G20 leaders at London should take a closer look at existing institutions, and how their capacity and incentives to play this role can be strengthened, for the challenges of the 21st century will require unprecedented levels of co-ordination. ♦

The African Development Bank: confronting crisis

The African Development Bank is stretching all its resources to respond to Africa's worsening crisis. At the G20 Africa has a voice, and the wider world must listen

By Donald Kaberuka, president, African Development Bank

The economic crisis could not have come at a worse time. Over the last decade, Africa has moved resolutely closer to the Millennium Development Goals. On the eve of the crisis, economies were growing. The investment climate had improved – as had political stability, democracy and accountability.

Achieving universal access to basic services and eradicating poverty remained key challenges. Structural weaknesses – extreme dependence on one or a few commodities, weak institutions and a high number of fragile states – continued to hold back African economies.

Nevertheless, Africa's score card was positive. African economies had grown by 7 per cent annually, raising real per capita income by 4 per cent. Crises could have been a thing of the past.

Two external shocks have obliterated this prospect: food prices and the economic impact of the financial crisis. In 2009, real per capita incomes will stagnate, a budget surplus of around 3 per cent in 2008 will develop into a deficit of a similar magnitude and the current account surplus of 3.8 per cent will become a deficit of 5.8 per cent.

It is paradoxical that we, who are so marginally integrated into the global economy, will feel the worst of its demise. The growth channels of yesteryear are today's contamination channel: commodity export revenue, stock markets, trade finance, foreign direct investment, remittances, tourism and access to capital markets.

Mines are closing, investments are being scaled down or cancelled, stock markets and currencies are falling and sectors dependent on international demand are shrinking rapidly. Trade finance lines have dried up. Competition over domestic finance by international firms crowds out local businesses, in some cases generating serious liquidity problems.

Africa's determination to adhere to two decades of reforms and structural adjustments demonstrates its commitment to change. Yet even countries committed to prudent fiscal and monetary frameworks and

economic liberalisation are affected. The position of Africa's largest economies – our regional growth engines – is visibly weakening. Few countries have sufficient fiscal space to counter this massive exogenous blow. As tax revenues shrink and export receipts decline, governments reduce expenditure levels. Infrastructure projects are the first casualties.

The speed at which the situation is deteriorating is astounding. Performance indices and forecasts become obsolete within weeks of publication. The African Development Bank (AfDB) has set up a Financial Crisis Monitoring Group to keep abreast of developments and guide our responses.

We convened a meeting of African finance ministers and central bank governors in Tunis for consultations. This meeting constituted a committee – the Committee of Ten – that met in January in Cape Town and in March in Dar es Salaam. It participated in UK prime minister Gordon Brown's Africa outreach meeting on 16 March.

In February, the heads of state and governments of the African Union deliberated at length on the report of the Committee of Ten to chart a way forward. They understand that the stability of the financial system is critical. They also legitimately expect to be part of the search for solutions and to have their broader concerns put on the table. Anything less will not provide a comprehensive, global, coherent solution.

The AfDB is stretching all the resources already at its disposal through front-loading, fast-tracked disbursements, portfolio restructuring and channelling resource to core business sectors, such as infrastructure, private sector, governance and regional integration.

For greater flexibility and responsiveness, the AfDB is forging ahead with more programmatic support operations, strengthening results-based management systems and reviewing processes to integrate the urgency of the situation. It is extending a set of additional crisis instruments to include an emergency liquidity facility and a trade finance instrument.

But these steps are not enough. The demand for concessionary and non-concessionary finance and grants has shot up. New lending commitments are expected to reach \$5.3 billion in 2009, \$7.3 billion in 2010 and \$11 billion in 2011 – almost twice the levels



forecast prior to the crisis. An agreement by the G20 leaders to positively consider discussions on general capital increases will provide capacity to be able to respond accordingly.

The G20 process must generate momentum to mobilise additional concessional resources in these exceptional times. The heads of the regional development banks support World Bank president Robert Zoellick's proposal for a 0.7 per cent vulnerability fund to be mobilised and flow through existing channels. We need to go further: simplifying negotiations for the International Development Association and the African Development Fund and structuring a longer replenishment period with interim reviews.

The crisis has revealed that there is no universal path to sustainable development within the overall paradigm of market-friendly policies. This lesson must inform a review of fiscal policy instruments shaping countries' access to resources.

Individually, we all have a duty to support our constituencies at times of crisis. Collectively, we have the opportunity to rewrite the script of our common future. We will not overcome by tinkering at the margin. We will not succeed if the voice of poor

The coffee harvest, Kenya: Africa has a stake in the commitments made at the 2005 G8 Gleneagles Summit

“Africa's determination to adhere to two decades of reforms and structural adjustments demonstrates its commitment to change”

countries, their concerns and their interests are not fully addressed.

Africa has a stake in the commitments made at the 2005 G8 Gleneagles Summit, in climate change and in reform of the international financial architecture. Africa and its people legitimately expect to sit around the table when these issues are discussed, to speak and to be heard. Lessons from today's crisis management must enable the global community to put in place a lasting stable architecture for tomorrow that promotes, sustains and spreads the benefits of globalisation to global citizens. ♦

Asia's challenge

ADB is helping to balance the needs of the poorest in Asia with sustainable and transforming economic growth

By Haruhiko Kuroda, president, Asian Development Bank

The G20 summit in London, on 2 April 2009, takes place in the midst of what many regard as the worst financial crisis since the Great Depression of the 1930s. In December 2008, the Asian Development Bank (ADB) forecast 5.8 per cent aggregate growth in gross domestic product

in developing Asia for 2009 – 3 percentage points lower than growth in 2007 and 1 percentage point lower than in 2008. Yet the downside risks, even to that pessimistic outlook, are mounting. Capital flows to the region have reversed, causing sharp swings in Asian market asset prices and sharp depreciations of many of the region's currencies. Many Asian economies have experienced difficulties in obtaining dollar funding, including funding for trade finance, and have seen a sharp rise in external borrowing costs. Liquidity and pricing strains in international funding markets are being transmitted to local credit markets. Because trade links between Asia and major industrial economies are substantial, the effects of a global recession are beginning to show in declining exports, tourism receipts and remittances.

Coming on the heels of the food, fuel and commodity price shocks, the financial crisis now threatens to become a full-scale economic and social crisis that could significantly set back the fight against poverty. Tighter credit conditions and weaker growth will likely cut into governments' ability to finance investment in infrastructure and to meet education, health and gender goals. Tighter credit is also reducing private investment flows, at a time when the region requires substantial amounts to finance priority development needs. The 1997-98 crisis nearly doubled the poverty rates in some of the region's developing countries, and the poor are usually the hardest hit and the least able to cope. If growth in 2009 and 2010 turns out to be one percentage point less than the growth in 2008 for 24 Asian countries, as predicted, the 21 million people who would have otherwise been freed from poverty will remain mired in it.

What developing Asia must do in response

These challenges demand co-ordinated action at the national, regional and global levels. Asia's response



must focus on three areas: containing the spillover effect of the crisis, rejuvenating its own sources of growth and continuing to tackle the region's long-term development challenges.

As in 1997, policymakers must take this opportunity to reassess their growth strategies. Asian countries today are substantially better prepared than they were in 1997, mainly as a result of policy reforms put in place over the past decade. Macroeconomic fundamentals are much healthier, with more prudent fiscal management, reduced external debt, more flexible exchange rate regimes and increased foreign currency reserves. Improvements to economic policies and institutional frameworks have also helped to build up economic resilience. Asia's banking and financial systems are now relatively robust.

But vulnerabilities remain. Despite a gradual decline in overall trade share, Europe, Japan and the United States still account for more than 60 per cent of final demand for all Asian exports. Because Asia can no longer rely on exports as its primary growth engine, it



On the heels of the food, fuel and commodity price shocks, the financial crisis now threatens to become a full-scale economic and social crisis





must build strong domestic demand to assure balanced and sustainable growth. Given high propensities to save and the still limited role of formal financial markets, public investment in physical and social infrastructure will play an important role in sustaining demand.

Asia's infrastructure financing gap is estimated to be as much as \$470 billion a year through to 2015. Social infrastructure, specifically on education and health care, also requires significant attention. A sustained level of economic activity in the region based on strengthened regional ties through existing regional arrangements – such as the Association of Southeast Asian Nations (ASEAN), ASEAN+3 and the East Asia Summit initiative – can also help.

Rebalancing the sources of growth while securing long-term development goals will be the key. There are compelling reasons for investing in Asia over the long term. Developing Asia, which includes two-thirds of the world's poor, represents the central front in the worldwide effort to reduce poverty and improve social welfare. Even before the financial crisis hit,

Developing Asia represents the central front in the worldwide effort to reduce poverty and improve social welfare

an estimated 911 million people lived below the poverty benchmark of \$1.25 a day. The Millennium Development Goals cannot be reached unless they are achieved throughout Asia. During times of crisis, global agendas such as the environment and climate change are at risk of being forgotten or delayed, creating a bigger burden for the future or potentially irreversible damage. As the most rapidly growing contributor to global greenhouse gas emissions, developing Asia must be central to the global battle to control climate change. By ensuring that the large investment still needed results in less energy- and natural resource-intensive economies, developing Asia can use its crisis response to achieve long-term structural changes.

How ADB can help

ADB is implementing measures to assist its members to contain the immediate effects of the global crisis and is stepping up its operations by several billion dollars from its originally planned \$12 billion in 2009. Funding for investment in infrastructure, rural development and social services will contribute to fiscal stimulus in the face of diminishing revenues. Fast-disbursing policy-based lending will help finance budget deficits while addressing economic distortions. ADB will also provide guarantees to foreign banks or private investors to encourage them back to emerging markets and will support trade financing through expanding a facility established for that purpose. At the regional level, ADB has strengthened its regional and national monitoring and surveillance. It is working closely with existing regional arrangements to support the development of a co-ordinated regional response.

ADB must balance the region's needs for protecting the poor during the crisis and sustaining growth and economic transformation in the years ahead. This is why ADB's crisis-related interventions are guided by Strategy 2020. This long-term framework emphasises inclusive and sustainable growth, regional co-operation and environmental sustainability. ADB can help its members overcome their near-term development challenges, while focusing on long-range development of physical and social infrastructure and finance, by minimising disruption to development programmes and projects. ADB can blend development finance with technical and economic skills in sectors that are crucial to recovery and long-term economic growth, such as transport, energy, water and sanitation, and environment and climate change.

These crucial challenges place significant demands on ADB's institutional strengths and financial resources. ADB is committed to repositioning itself to become a more innovative and effective development partner in the region and within the international aid architecture. Still, ADB faces constraints that require a prompt and robust capital increase, in order to play a truly meaningful role in the future economic and social development of the region and to respond to the short-term global financial and economic crisis. Sustainable growth in Asia can help the global recovery be more prompt and robust, and ensure that poverty reduction and a cleaner environment accompany economic expansion. ♦

Development out of crisis

The IDB has acted swiftly in response to the demands of G20 leaders that development banks adapt their development agendas to meet the needs of members more efficiently

By Luis Alberto Moreno, president, Inter-American Development Bank

The new international environment has added a new short-term dimension to the challenges that the Latin American and Caribbean region have been facing in terms of sustainable and inclusive growth, as a result of the liquidity needs generated first by the food crisis and then by world financial instability. The Inter-American Development Bank (IDB) is responding to the current global economic and financial crisis in several ways. The IDB began to take these steps before the leaders of the G20 met in November 2008 in Washington, but those steps are fully consistent with the principles and action plan set forth in the G20 communiqué.

The G20 leaders exhorted the multilateral development banks to use their full capacity in support of their development agenda and to adapt their lending instruments to meet more adequately their members' new needs.

The IDB has acted swiftly in offering a determined countercyclical response. It has exercised regional leadership by addressing the liquidity problems in international markets, launching its \$6 billion Liquidity Program for Growth Sustainability (LPGS) in the first week of October 2008. This initiative provides resources for central banks and governments to lend to the productive sectors through commercial banks facing transitory liquidity constraints. Several countries have already asked for support from the programme. In December the IDB approved two operations for a total of \$900 million. This entire effort is being co-ordinated with other multilateral organisations.

Consistent with the G20's call to immediately adopt measures to strengthen supervision, the IDB has provided countries with rapid access to technical assistance to strengthen the regulatory framework, bank resolution mechanisms and technical capacities, so that regulatory bodies can better address the potential effects of the crisis on local financial markets. The IDB is working with the Multilateral Investment Fund to establish a line of activity for financial regulators to allow for a rapid approval and implementation of eligible programmes.

This involves supporting the integrity of the financial sector in the region against an increased risk of illicit financial activity as a result of the need for liquidity. The IDB is concluding a study of recent country evaluations on anti-money laundering in order to prepare to provide technical assistance to prepare systemic risk analysis and the corresponding anti-money laundering strategies.

Furthermore, the IDB is determined to use its resources with the maximum benefit for the countries of the region. As a result, the 2009 IDB agenda calls for deepening the policy and programme dialogue with each member country, in order to better allocate resources with the goal of maximising its developmental impact as well as assisting countries in their responses to the crisis. The IDB intends to use the available resources that its financial policies permit, establishing a lending programme in line with both the needs of the region's economies and the IDB's capacity. Therefore, it is prepared to increase lending from an annual average of about \$7.5 billion between 2002 and 2007 to more than \$11 billion in 2008 and up to \$12 billion in 2009, beyond what it must provide through the LPGS or emergency lending.

The challenges posed by the crisis require a more agile and flexible operation of IDB projects. Thus, it will continue improving portfolio management and disbursement levels, paying particular attention to speed up not only project approvals but also the full execution of operations. The changes made to execution procedures, delegation of responsibilities to the country offices and the use of country procurement and fiduciary oversight systems should bring about a structural change in disbursement volumes over the next two years. Moreover, to help better target the development impact, the IDB recently approved the Development Effectiveness Framework, which will sharpen the focus on development results, both for its financial products and for its knowledge and capacity-building products.

To further improve efficiency, in October 2008, IDB staff presented to the board of executive directors a new operational framework that sets out a strategy to ensure the IDB's regional relevance in the coming years. The framework includes expanding the institution's ability to play a countercyclical role.

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The IDB is determined to use its resources with the maximum benefit for the countries of the region

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The IDB is responding to the request of the G20 leaders for the multilateral development banks to review the adequacy of their resources. It is currently considering whether an increase in either the Fund for Special Operations or in the ordinary capital resources is needed, given the development needs in the region and the real decline in the IDB's financing capacity since the Eighth Replenishment Agreement in 1994. To address these requirements, the staff are analysing the appropriate scale of the IDB and hope to have some preliminary findings to be discussed with governors at the annual meeting in Colombia in March 2009.

Since the IDB's last recapitalisation in 1994, economic activity in Latin America and the Caribbean has grown two-fold, while its lending capacity has gone unchanged. The development agenda of the region not only remains a priority, but has also become broader, with a renewed mandate of fighting poverty and enhancing equity while promoting sustainable growth.

Latin America and the Caribbean today needs a sound, innovative and flexible institution, with more financial muscle to be able to make a significant

Guri hydroelectric dam, Venezuela: the development agenda of the region remains a priority, with a renewed mandate of fighting poverty while promoting sustainable growth

contribution to the development of IDB member countries. The current economic crisis confirms the validity of that vision of the institution and adds urgency. It calls upon the IDB to redouble efforts to make that vision a reality.

In the last ten years, the region has achieved a period of solid growth, underpinned by sound macroeconomic policies. The global financial crisis is putting these economic and social achievements at risk, and will force governments to make difficult policy choices. This crisis poses key challenges in the short term that must be faced with urgency but without distracting the IDB from its long-term goals.

All efforts must be aimed at protecting those living in poverty and extreme poverty by prioritising public expenditure to shield these groups from the impact of decreasing growth rates. We need to mitigate this crisis to save the region from poverty and inequality. By defending today the social and economic gains of Latin America and the Caribbean in the last decade, we are laying the foundations for the return of solid and sustainable growth for the future. ♦



Children greet dignitaries at the Commonwealth Heads of Government Meeting 2007, Kampala, Uganda

Global reform, global action

Many of the principles set out by the Commonwealth are reflected in the work of the G20: with inclusion comes legitimacy

By Kamallesh Sharma,
Commonwealth
secretary general

The G20 has burst into public consciousness over the past six months. With 90 per cent of global gross domestic product and two-thirds of world trade and population, that is where it should be. It is no longer an acronym confined to the shadowy world of finance ministers and central bankers. Rather, its emergence as a grouping involving heads of state and government is a recognition of the fact that dealing with global challenges – and specifically the global financial and economic crisis – demands a new breadth, depth and intensity of international co-operation.

This new-found status is both welcome and incomplete. It is welcome because it shows that the profound political and economic changes that have affected the world over the past generation are being reflected in the structures of global governance. The post-war fault lines of North-South and East-West are being replaced by a more integrated and interdependent world. This integration has opened the possibility of huge advances in prosperity for many. But as these interactions have supported economic progress, it is also clear that individual national decisions have international consequences. As events have shown, collective action among a wider group of systemically important countries is more necessary than ever before.

But this advance in comprehensiveness is also incomplete. It is the fate of economists – as with generals – to be fighting the last war. The insight that the narrow circle of power needs to be widened – with the inclusion of the economically important and powerful emerging markets as equal partners in tackling today's problems – is welcome and right. However, this is a necessary but not sufficient condition for a stable, inclusive and prosperous world.

The G20 is now engaged in three vital tasks: promoting international collaboration to prevent spiralling global economic decline, shaping the regulatory framework of the financial sector to prevent a repeat of the crisis and reforming the international

financial institutions to support future co-operation for stability and prosperity. Agreement among the members of the G20 in each of these areas is essential to any progress. Yet it is vital to recognise that the decisions of the G20 have an impact that is at least as important to the more than 180 countries containing nearly half the world's population who have no seat at the table as it is to those countries present.

These 180 countries look to the G20 for decisive action to ensure macroeconomic stability. The consequences for developing countries of a global slump can be catastrophic in human terms. Equally, they look for support in managing the uncertainties in the global economy. This means adequately resourcing the international financial institutions, including the regional development banks, and maintaining aid levels.

The Commonwealth brings together 53 countries in a voluntary association. The group covers the full range of countries – from five members of the G20 to a number of the smallest countries on earth. The membership is bound together by a common perspective – a commitment to democracy, an attachment to mutual co-operation and a value for the views of each, regardless of size.

From the perspective of this larger grouping there are two areas where the work of the G20 is particularly important. The first is in the remaking of the international financial institutions. At their meeting in 2007, Commonwealth heads of government expressed unease that the operations and governance of those institutions had become outdated. The leaders called for reform. In the middle of 2008 a small representative group of Commonwealth heads of government met to consider in more detail what reform was required. They set out a number of important principles to guide the reform effort and specifically looked for a global process through which fundamental reform of the Bretton Woods institutions would be implemented. Commonwealth members have endorsed these principles and are committed to seeing their practical implementation.

The G20's commitment to further reform of the International Monetary Fund and the World Bank echoes this call. Many of the principles set out by

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In 2007, Commonwealth heads of government expressed unease that the operations and governance of those institutions had become outdated

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A worker at the Thyagraj sports complex, one of the venues for the Commonwealth Games 2010, New Delhi, India



With inclusiveness comes the legitimacy needed to underpin international co-operation



the Commonwealth are already reflected in the work of the G20, notably the need for transparency, accountability, inclusiveness and legitimacy. But it is the Commonwealth's belief that any process of reform must be inclusive. Thus it is crucial to the success of this reform that the G20 actively seeks the views of non-member countries through a structured process of consultation: global reform demands global action. This consultation process should be one of the key outcomes of the April G20 summit. A well-designed and well-conducted process can blaze a trail for tackling issues of global public policy. With inclusiveness comes the legitimacy needed to underpin international co-operation. The Commonwealth experience is that decisions taken with the informed consent of all command loyalty and agreement. All states, irrespective of size and endowment, have legitimate expectations from global financial governance and a right to have them seriously considered.

The second area where Commonwealth members look for leadership from the G20 is trade. The smallest and least developed economies are most vulnerable to the breakdown of a multilateral and rules-based system of trade. The G20 has a global obligation both to resist the siren call of protectionism and to deliver on the promises, too long denied, to deliver a global trading system that supports the aspirations of developing economies.

And it is important that – even now – the international community looks forward. The financial crisis has prompted a new interest in and commitment to the need for global co-operation. That co-operation is also needed to tackle the other great global challenges: the eradication of global poverty through advancing universal global prosperity, meeting the Millennium Development Goals and achieving sustainable development, including avoiding uncontrolled climate change and tackling resource scarcity, whether of energy or water or food. These issues are complex and required urgent action even before the economic events of the past 12 months. The aim of all in the G20, in the Commonwealth and beyond, must be to bring new resolve to meeting these challenges equitably and for the benefit of all.

The modern Commonwealth is 60 years old in 2009. Its work in support of international co-operation has always been rooted in common values, responsiveness and practicality. In serving a new generation now, it has at its heart the same concerns of the G20: to move from a partial globalisation to an inclusive globalism. 'Globalisation' is a fact – whereas 'globalism' is the mindset that informs the belief that collective challenges need collective solutions to achieve collective goals. We must hear and heed the voice not of the few, but of all. ♦

Argentina

Cristina Fernández de Kirchner



Cristina Fernández de Kirchner became president of Argentina on 10 December 2007 after winning the general election in October. She replaced her husband, Néstor Kirchner, who was president from May 2003 to December 2007. She is Argentina's second female president, but the first to be elected. Prior to her current position, she was a senator for Buenos Aires province and Santa Cruz province. She was first elected to the Senate

in 1995, and in 1997 to the Chamber of Deputies. In 2001 she won a seat in the Senate again. Born 19 February 1954 in La Plata, Buenos Aires, she studied law at the National University of La Plata. She and her husband were married in March 1975 and have two children.

Australia

Kevin Rudd



Kevin Rudd became prime minister of Australia on 3 December 2007, replacing John Howard, who had held the position since 1996. Before entering into politics, Rudd worked for the Department of Foreign Affairs, where he held posts in Sweden and China. He also spent time as a political staffer and held positions that included chief of staff for the premier of Queensland and director general of the office of the Queensland cabinet. Rudd

first ran for office in 1996, but was not successfully elected until 1998. Since then he has served in various positions including shadow minister of foreign affairs and leader of the opposition. He was born in Nambour, Queensland, on 21 September 1957. He earned a bachelor's degree in Asian studies at Australian National University in 1981, where he focused on Chinese language and history. He and his wife, Thérèse Rein, have three children.

Brazil

Luiz Inácio Lula da Silva



Luiz Inácio Lula da Silva first assumed the office of the president on 1 January 2003 after being successfully elected in October 2002. He was re-elected in October 2006, extending his term until January 2011. 'Lula' first ran for office in 1982 in the state of São Paulo, but it was not until 1986 that he was first elected to congress. He did not run for re-election in 1990. Instead, he became more involved in the Workers' Party, where he continued to run for

the office of the president. He was born in Caetés, Pernambuco, Brazil, on 27 October 1945. He received no formal education and began working in a copper pressing factory at the age of 14. He became heavily involved in the workers unions at a young age. He is married to Marisa Leticia and has five children.

Canada

Stephen Harper



Stephen Harper was first elected prime minister of Canada in January 2006, assuming office from Paul Martin in February and leading a minority government. He later ran for re-election in October 2008 and returned to the House of Commons with a stronger minority. Before running for politics he served as a policy advisor for the Reform Party. Harper first ran for a seat in the House of Commons in 1988, but was not successfully elected until

1993. He served as leader of the opposition for a number of years before becoming prime minister. He was born in Toronto, Ontario, on 30 April 1959. He studied economics at the University of Toronto and the University of Calgary, later returning to the University of Calgary to earn his master's degree in economics in 1991. He and his wife, Lauren Harper, have two children.

China

Hu Jintao



Hu Jintao has been president of the People's Republic of China since 15 March 2003. He replaced Jiang Zemin, who had held the position since 1989. Hu also serves as general secretary of the Communist Party of China's (CPC) Central Committee and chair of the Central Military Commission. Before entering into politics he worked as an engineer. He joined the CPC in April 1964, and began working with the party in 1968. In 1992,

he was elected to the Standing Committee of the Political Bureau of the CPC Central Committee and re-elected in 1997. He became vice-president of China in March 1998 and vice-chair of the Central Military Commission in 1999. In November 2002, Hu was elected general secretary of the CPC Central Committee. He was born in Jiangyan, Jiangsu, on 21 December 1942. In 1965 he received his engineering degree from Tsinghua University. He is married to Lui Yongqing and they have two children.

France

Nicolas Sarkozy

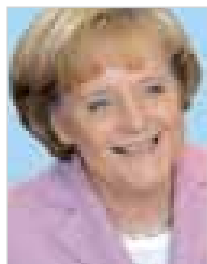


Nicolas Sarkozy became president of France on 16 May 2007, taking over from Jacques Chirac, who had held the position since 1995. He worked as a lawyer while he pursued politics. From 1983 to 2002, he was mayor of Neuilly-sur-Seine. He has been president of the Union pour un Mouvement Populaire, France's major right-wing party, since 2004. During his time in parliament he has held a number of cabinet portfolios including minister of state

of economy, finance and industry, minister of the budget and minister of the interior. He was born in Paris on 28 January 1955. In 1978, he received his law degree from the Université de Paris. He is married to Carla Bruni and has three children from his two previous marriages.

Germany

Angela Merkel



Angela Merkel became the first female chancellor of Germany on 22 November 2005, replacing Gerhard Schröder, who had been in power since 1998. Before entering into politics Merkel worked as a researcher and physicist. She was first elected to the Bundestag in 1990 and has held the cabinet portfolios of women and youth, environment, nature conservation and nuclear safety. She was born in Hamburg on 17 July 1954. In 1978, she received her

doctorate in physics from the University of Leipzig. She is married to Joachim Sauer and has no children.

India

Manmohan Singh



Manmohan Singh became prime minister of India on 22 May 2004, replacing Atal Bihari Vajpayee, who held the position from 1998 to 2004, and also for a short period in 1996. Before entering into politics, Singh worked as an economist, including for the International Monetary Fund. He was governor of the Reserve Bank of India from 1982 to 1985. Singh was first elected to the upper house of Indian parliament in 1995. He was re-elected

in 2001 and 2007 and held cabinet positions including minister of finance and minister for external affairs. Singh also served as minister of finance from November 2008 to January 2009. He was born in Gah, Punjab (now known as Chakwal district, Pakistan), on 26 September 1932. He received his bachelor's and master's degrees from Punjab University in 1952 and 1954. He also received an additional undergraduate degree from Cambridge University in 1957 and a doctorate from Oxford University in 1962. He and his wife, Gursharan Kaur, have three children.

Indonesia

Susilo Bambang Yudhoyono



Susilo Bambang Yudhoyono became president on 20 October 2004 after winning the election in September, replacing the incumbent Megawati Sukarnoputri. Before entering into politics, he served as a lecturer and a military general. His first experience in politics came when he was appointed minister of mines and energy in 1999. He later served as co-ordinating minister for politics and security.

He was born on 9 September 1949 in Pacitan, East Java. He received his doctorate in agricultural economics from the Bogor Institute of Agriculture in 2004. He and his wife, Kristiani Herawati, have two children.

Italy

Silvio Berlusconi



Silvio Berlusconi became prime minister of Italy for the fourth time after winning the April 2008 election. Before entering politics, he started his career as a building contractor. In 1980, he established Canale 5, the first private national television network in Italy. He also became a leading Italian publisher with Mondadori. In 1994 he resigned from all his posts at Gruppo Fininvest in order to establish the political movement Forza Italia and, in the

same year, he became president of the Council of Ministers for the first time. In June 2001 Berlusconi became premier again, an office he held until 2006. In 2009, for the third time, he chairs the presidency of the G8. Born in Milan on 29 September 1936, he received his law degree from the University of Milan. He is married to Veronica Lario and has five children.

Japan

Taro Aso



Taro Aso became prime minister of Japan on 24 September 2008, replacing Yasuo Fukuda, who held the position since September 2007. Before entering into politics, Aso worked in mining. He was first elected to the House of Representatives in 1979 and has been re-elected eight times. He has served in a variety of positions in government including minister of foreign affairs and minister of international affairs and communications. He was born

in Iizuka, Fukuoka, on 20 September 1940. He studied politics and economics at Gakushuin University as well as Stanford University and the London School of Economics. He was also a member of the Japanese shooting team that competed at the 1976 Olympics. He is married to Chikako Aso and they have two children.

Mexico

Felipe Calderón Hinojosa



Felipe Calderón Hinojosa became president of Mexico on 1 December 2006, replacing Vicente Fox, who held the position from 2000 to 2006. In his early twenties Calderón was president of the youth movement of the National Action Party. He later served as a local representative in the legislative assembly in the federal chamber of deputies. In 1995 he ran for governor of Michoacán. He served as secretary of energy from 2003 to 2004. Born

in Morelia, Michoacán, on 18 August 1962, he received his bachelor's degree in law from Escuela Libre de Derecho in Mexico City. He later received a master's degree in economics from the Instituto Tecnológico Autónomo de México as well as a master's degree in public administration from Harvard University. He and his wife, Margarita Zavala, have three children.

Republic of Korea

Lee Myung-bak



Lee Myung-bak became president on 25 February 2008, replacing Roh Moo-hyun, who had occupied the position since 2003. Lee joined the Hyundai Construction company in 1965 and eventually became chief executive officer of the Hyundai Group before being elected to the Korean National Assembly in 1992. In 2002 he was elected mayor of Seoul, a position he held until 2006. He was born in Kirano, Osaka, Japan, on 19 December 1941.

He received a degree in business administration from Korea University in 1965. Lee and his wife, Kim Yun-ok, have four children.

Russia

Dmitry Medvedev



Dmitry Medvedev became president of Russia on 7 May 2008 after winning the presidential election in March, replacing Vladimir Putin, whose term in office had expired. Before entering politics, Medvedev worked as a legal expert and lawyer. He was officially endorsed as a presidential candidate on 17 December 2007 by Russia's largest political party, United Russia, as well as by Putin. Medvedev served as deputy prime minister from 2005 to 2008. He

was born in Leningrad (now St Petersburg) on 14 September 1965. He earned a degree in law in 1987 and a doctorate in private law in 1990 from Leningrad State University. He is married to Svetlana Medvedeva and they have one child.

Saudi Arabia

Abdullah bin Abdul Aziz Al Saud



King Abdullah bin Abdul Aziz Al Saud has been in power since August 2005. He replaced Fahd bin Abdul Aziz Al Saud, who had reigned since June 1982. As crown prince since 1987, King Abdullah had previously acted as de facto regent and thus ruler since 1 January 1996, after Fahd had been debilitated by a stroke. He was formally enthroned on 3 August 2005. He also serves as prime minister of Saudi Arabia and commander of the National Guard.

King Abdullah is chair of the supreme economic council, president of the High Council for Petroleum and Minerals, president of the King Abdulaziz Centre for National Dialogue, chair of the Council of Civil Service and head of the Military Service Council. He was born 1 August 1924 in Riyadh and has a number of wives and children.

South Africa

Petrus Kgalema Motlanthe



Petrus Kgalema Motlanthe became president of South Africa on 25 September 2008 after the resignation of Thabo Mbeki, who had held the position since 1999. In the 1970s Motlanthe worked for the Johannesburg city council and later served as secretary general of the National Union of Mineworkers. He became secretary general of the African National Congress in 1997. He was elected deputy president in December 2007. He became a member of

parliament in May 2008 and in July was appointed to cabinet without a portfolio. Born on 19 July 1949 in Alexandra, Johannesburg, Motlanthe has three children with Mapula Motlanthe.

Turkey

Recep Tayyip Erdogan



Recep Tayyip Erdogan became prime minister of Turkey on 14 March 2003, replacing Abdullah Gül, who had occupied the office since 2002. Before becoming prime minister, Erdogan was mayor of Istanbul from 1994 to 1998. He was born on 26 February 1954, in Rize, Turkey, and studied management at Marmara University's faculty of economics and administrative sciences. He is married to Emine Erdogan and has two children.

United Kingdom

Gordon Brown



Gordon Brown became prime minister of the United Kingdom of Great Britain and Northern Ireland on 27 June 2007, three days after becoming leader of the Labour Party. He was first elected to parliament in 1983 as representative for Dunfermline East. Since 2005 he has been the representative for Kirkcaldy and Cowdenbeath, both in Scotland. Before entering politics he worked as a lecturer and journalist. He served as chancellor of the exchequer from 1997 to 2007. As the United Kingdom holds the chair of the G20 for 2009, Brown will host the London Summit on 2 April 2009. He was born in Govan, Glasgow, on 20 February 1951. He studied history at the University of Edinburgh and completed his doctorate in 1982. He and his wife, Sarah, have two children.

United States of America

Barack Obama



Barack Obama became president-elect on 4 November 2008 and was inaugurated 20 January 2009, replacing George W Bush. In 2005 Obama was elected to the Senate, having previously worked as a community organiser, a civil rights lawyer and a state legislator for Illinois. The first black president of the United States, he was born on 4 August 1961, in Honolulu, Hawaii, to a Kenyan father and American mother. He received his bachelor's

degree from Columbia University in 1983 and a law degree from Harvard University in 1991. He is married to Michelle Obama and they have two children.

European Union

Mirek Topolánek



On 1 January 2009, the Czech Republic assumed the six-month presidency of the European Council from France. The Czech prime minister Mirek Topolánek has been prime minister since 16 August 2006. He was a member of the Senate from 1996 to 2004 and its deputy chair from 2002 to 2004. Since June 2006 he has been a member of the Chamber of Deputies. Born in 1956, Topolánek received his degree in mechanical engineering from the

Brno University of Technology. He is separated from his wife, Pavla Topláňková, and has four children.

José Manuel Barroso



José Manuel Barroso became president of the European Commission on 23 November 2004. Previously he was prime minister of Portugal from 2002 to 2004. Before entering politics Barroso was an academic. He studied law at the University of Lisbon, holds a master's degree in economics and social sciences from the University of Geneva and received his doctorate from Georgetown University in 1998. He is married to Maria Margarida Pinto Ribeiro de

Sousa Uva and has three children.

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Addressing International Governance Challenges

The Centre for International Governance Innovation (CIGI) is an independent, non-partisan think tank that addresses international governance challenges. Led by a group of experienced practitioners and distinguished academics, CIGI's objective is to anticipate and further understand emerging trends in international governance, particularly economic and financial governance, and to strengthen multilateral responses to the world's problems.

Major research projects and initiatives are grouped under the following six international governance themes: Environment and Resources; Global and Human Security; Health and Social Governance; International Economic Governance; International Law, Institutions and Diplomacy; and Shifting Global Order.

Working behind the scenes since 2003, CIGI's Breaking Global Deadlocks project has led a "Track II" process to make the case for raising the G20 Finance Ministers group to Leaders level. This informal and confidential process involves a network of think tanks and serving and retired senior officials from around the world. It focuses on a central hypothesis: to deal effectively with world-scale problems in a globalized, post-unipolar world, the architecture of international relations requires leadership, in effect a steering group and agenda setting committee at leaders' level. Some 30 "Track II" meetings have been held around the world over the last five years to examine in detail the proposal for an expanded group of leaders as an international problem-solving mechanism.

CIGI is currently focusing its research capacities on the impact of the global financial crisis on the international institutions and regulatory regimes and authorities. Experts are working to gain a better understanding of how the elements of this crisis will impact various governance mechanisms; to explore what the role of China and other emerging economies in the new financial world order will be; and to examine what future G20 summits can accomplish.

Examples of Recent Work

The G20 Leaders' Summit and the Regulation of Global Finance: What was Accomplished?

Eric Helleiner and Stefano Pagliari,
CIGI Policy Brief #11, December 2008

International Payments Imbalances and Global Governance

Eric Helleiner,
CIGI Policy Brief #8, November 2008

Global Governance for a Global Age: The Role of Leaders in Breaking Global Deadlocks

Barry Carin and Ramesh Thakur,
CIGI Policy Brief #7, November 2008

The BRICSAM Countries and Changing World Economic Power: Scenarios to 2050

Manmohan Agarwal,
Working Paper #39, October 2008

Emerging Powers in Global Governance: Lessons from the Heiligendamm Process

Book edited by Andrew F. Cooper,
Agata Antkiewicz, October 2008

Global Governance and Diplomacy:

World's Apart?, Book edited by Andrew F.
Cooper, Brian Hocking and William Maley
July 2008

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