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International Financial
Architecture: an Asia-Pacific
Perspective**

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Abstract

The views expressed in this Working Paper are those of the author(s) and should not necessarily be considered as reflecting the views or carrying the endorsement of the United Nations. Working Papers describe research in progress by the author(s) and are published to elicit comments and to further debate. This publication has been issued without formal editing.

The first section of the paper narrates origin and evolution of Group of Twenty (G-20). The second section reviews its contribution while the third provides assessment and prospects for G-20. The fourth section mentions possible approaches to reforms of the international financial architecture. The concluding part elaborates on the new realities that G-20 should take note of and makes a brief reference to the importance of India in the process.

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G-20 Agenda and Reform of the International Financial Architecture: an Asia-Pacific Perspective

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1. ORIGIN AND EVOLUTION OF G-20

The Group of Twenty (G-20) Finance Ministers and Central Bank Governors was established in 1999 to bring together systemically important industrialized and developing economies to discuss key issues in the global economy. The inaugural meeting of the G-20 took place in Berlin, on December 15-16, 1999, hosted by German and Canadian finance ministers. The G-20 is made up of the finance ministers and central bank governors of 19 countries (since 2008 the G-20 is being held at Summit level also, in response to the global financial crisis). These are: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, Republic of Korea, Turkey, United Kingdom, United States of America.

The European Union, which is represented by the rotating Council presidency and the European Central Bank, is the 20th member of the G-20. To ensure that global economic fora and institutions work together, the Managing Director of the International Monetary Fund (IMF) and the President of the World Bank, plus the chairs of the International Monetary and Financial Committee and Development Committee of the IMF and the World Bank, also participate in G-20 meetings on an ex-officio basis. In response to the criticism that it is not inclusive enough, each G-20 Summit now has up to five special invitees to improve outreach, namely Spain, and a representative each from Asia and Africa. The G-20 thus brings together important industrial and emerging-market countries from all regions of the world. Together, member countries represent around 90 per cent of global gross national product, 80 per cent of world trade (including EU intra-trade) as well as two-thirds of the world's population. The G-20's economic weight and broad membership gives it a high degree of legitimacy and influence over the management of the global economy and financial system.

Unlike international institutions such as the Organization for Economic co-operation and Development (OECD), IMF or World Bank, the G-20 (like the G7/G8) has no permanent staff of its own. The G-20 chair rotates between members, and is selected from a different regional grouping of countries each year. In 2010 the G-20 chair is the Republic of Korea, and in 2011 it will be France. The chair is part of a revolving three-member management Troika of past, present and future chairs. The incumbent chair establishes a temporary secretariat for the duration of its term, which coordinates the

group's work and organizes its meetings. The role of the Troika is to ensure continuity in the G-20's work and management across host years.

It is normal practice for the G-20 finance ministers and central bank governors to meet once a year. The ministers' and governors' meeting is usually preceded by deputies' meetings and extensive technical work. This technical work takes the form of working groups, expert groups, workshops, reports and case studies on specific subjects, that aim to provide ministers and governors with contemporary analysis and insights, to better inform their consideration of policy challenges and options.

The country currently chairing the G-20, posts details of the group's agenda, meetings and work program on a dedicated website. Although participation in the meetings is reserved for members, the public is informed about what was discussed and agreed immediately after the meeting of ministers and governors has ended. After each meeting of ministers and governors, the G-20 publishes a communiqué which records the agreements reached and measures outlined. Material on the forward work program is also made public.

Till the Asian crisis, the unstated global economic order has been that G-7 / G-8 countries (Canada, France, U.S., U.K., Germany, Japan, Italy and Russia), constituted the centre and the rest of the world was essentially periphery, which will have to adjust its economies to what happens in G-7 / G-8. The Asian crisis made it clear that the impact was not necessarily one way, and there may be occasions when there can be transmission of risks from developing countries to G-7 / G-8. However, there was a fundamental assumption that the ideologies, codes of practices based on the ideologies, and standards of governance and transparency of G-7 / G-8 should be adopted by all countries, and that such an approach would reduce the risks to global economy. Financial Stability Forum (FSF) was thus created with membership of advanced economies and a few international financial centres, but did not include large economies like India or China. In a way, perhaps as an after thought, this lacuna was made up by the creation of G-20 which was expected to take a broader view of the inter-related aspects of global economy.

The G-20 meetings which were somewhat ad hoc in the beginning were formalized through G-20 Policy Manual in December 2006. From 1999 till 2008, G-20 was essentially a discussion forum which ended in the issue of a communiqué. During this period, several events led to a situation when resources of International Monetary Fund (IMF) were not in demand, and some questioned the continued relevance of IMF. The global economy seemed to be running in an impressive fashion without relevance to the active involvement of G-20 or FSF or IMF. However, G-7 / G-8 continued to have its premier role, though select representatives of important emerging market economies were invited to the meetings for essentially non substantive events. There were, no doubt, some concerns about persistent global economic imbalances with main focus on deficits of USA and surpluses of China.

The financial crisis of 2008 came as a rude shock to the global community in particular to the advanced economies. Firstly, the centre (G-7/G-8) became the origin of the crisis. Second, the periphery (developing countries) became innocent victims, but was less affected. Third, the financial crisis was spilling over into serious economic, and possibly, a social crisis. It was clear that the crisis in 2008 was essentially global in

nature, and the policy responses had to be globally coordinated. These events led to initiation of Summit Meetings of G-20 in November 2008, in Washington D.C., with USA and U.K. taking a lead in the process. Since then, there have been Summit Meetings at the level of heads of states or of governments. In the context of management of the crisis and creating a post-crisis world that would be more secure and stable than before, G-20 evolved as the most important economic policy forum in the world. It has been formally declared by G-20 leaders as the premier international forum for global economic cooperation. It has also been described as the fourth pillar of global economic governance, the other three being IMF, World Bank and World Trade Organisation.

2. REVIEW OF CONTRIBUTION OF G-20

The work of G-20 is noteworthy after the global financial crisis. First, G-20 provided a forum for discussing the global financial crisis of 2008, and necessary measures to be taken to avoid a collapse of the financial systems and onset of deflationary tendencies and possible depression. There was a broad agreement on policy measures to be taken on an immediate basis by different countries for stimulating the depression-threatened economies and avoiding protectionist measures. Undoubtedly, all the actions have been at the national level, but broad contours were agreed upon and monitored in G-20. There is a broad consensus in the G-20 Toronto Summit declaration of June 26-27, 2010 that these efforts have borne “good results”. Unprecedented and globally coordinated fiscal and monetary stimulus has helped in restoring some private demand and lending, and thus avoiding depression in global economy.

Secondly, in the recent meeting in June 2010, the exit from extra-ordinary stimulus measures was considered. It has not been possible to arrive at similar agreements on specific coordinated actions in the G-20 for exit. However, it was recognized that follow-up on existing stimulus plans may involve continuation of stimulus in some countries, and initiation of exit policies in some others. In any case, there was a broad agreement that fiscal sustainability was important to all countries. In brief, there has been some disappointment at a lack of agreement on globally coordinated actions, but there has been some comfort that fiscal sustainability as well as diversity in the economic conditions of different countries has been recognized.

Thirdly, a framework for strong sustainable and balanced growth was agreed among G-20 countries. This essentially provides a broad agreement on what appears to be specific appropriate policy parameters for macro economic management in each country, consistent with the needs of a globalised economy. It was also agreed that there should be a process of mutual assessment of relevant national level economic policies in relation to the agreed framework. In Toronto, there was an agreement that the second stage of country led and consultative mutual assessment will be conducted at the country and European level. It was also agreed that additional measures, as necessary, will be identified to achieve strong sustainable and balanced growth. It is significant that there is some agreement (a) on the best practices; (b) on peer pressure through monitoring; and (c) on need for changes in the measures appropriate for each country to meet evolving situations.

Fourthly, there has been a continuous focus on financial sector reform. The reform agenda was admittedly based on four pillars, viz., strong regulatory framework; effective supervision; resolution and addressing systemic institutions; and transparent international assessment and peer review. The work of G-20 on these issues has been virtually outsourced to a newly established institution, viz., Financial Stability Board (FSB). It may be noted that a considerable convergence has been obtained in the country-representation between G-20 and the newly created FSB. Members of G-20, such as China, India and Indonesia, which were not members of Financial Stability Forum (FSF), are now part of FSB. Some countries in G-20 have, in the meantime, initiated measures related to regulatory structures, macro and micro prudential requirements, and incentive mechanisms. Much of the corrective actions under consideration have so far been directed at rolling back excessive deregulation and the actions at national level have mainly been in advanced economies where the financial sector has been severely affected. U.S.A., U.K. and European countries continue to dominate the thinking process on regulation of financial sector and there are genuine apprehensions that the financial markets would have commanding influence on the outcomes. Currently, there are three, somewhat contentious, issues in G-20, viz., the time span over which the new regulatory regime would come into effect, treatment of systemically important financial institutions and taxes on financial sector.

Fifthly, the reforms of international financial institutions have been on the agenda, both for meeting the immediate requirements of managing the crisis and for strengthening the International Financial Architecture (IFA). To this end, additional resources were made available to the IMF and to the multi-lateral development banks on the basis of indications given by G-20. There has also been an agreement on review of quota and enhancement of voice for developing countries. The G-20 maintains that it is committed to reforming the mandates, and governance in the international financial institutions to reflect changes in the world economy and the new challenges of globalization.

Even-handed candid and independent IMF surveillance is emphasized by G-20, and IMF is being encouraged to strengthen its bi-lateral and multi-lateral surveillance including macro financial linkages. IMF is also being encouraged to work on important subjects, such as the International Monetary System and the scope for tax of financial sector. In addition, the Finance Ministers and Central Bank Governors have agreed to prepare policy options on sound incentives to strengthen global financial safety-nets.

Finally, broader developmental aspects, such as, financial inclusion, financing for small and medium industries, elimination of fossil fuel subsidies, and anti-corruption have also been on the agenda of G-20. Attention has been paid to the issue of tax-havens and the scope for global axes on financial sector, but there is lack of agreement on specific measures.

3. ASSESSMENT AND PROSPECTS FOR G-20

G-20 has been welcomed by the global community for several reasons. There is a better representation of emerging market economies and a better reflection of changing economic realities at the global level. The group is fairly representative, covering about 80% of population income, trade, investment, etc. Though it has not formally replaced

G-7 / G-8, it is increasing in its importance in providing a forum for agreement on cooperative actions in multi-lateral institutions, and coordinated policies at national level consistent with needs of increasingly globalizing economy. With the participation of chairs of International Money and Finance Committee and Development Committees in the meetings, there is effective representation of global bodies to assume a high level of coordination on matters relating to global economic governance.

There have also been several criticisms of G-20 framework. It has been argued that G-20 cannot claim to represent all the 192 countries that are members of United Nations. It has no formal legitimacy in the sense that there is no law or treaty backing the G-20. In fact, they indicate that G-20 is an extra constitutional authority operating like a cartel of powerful suppliers of what they consider to be global economic goods. Its operating arms, especially in IMF, are admittedly suffering from flawed governance. Hence, its policies are likely to continue to suffer from credibility. There is a compulsion for communication at the end of every Summit and hence the pressure is on agreement and transparency than problem solving and structural transformation. G-20 has been vague and circumspect in taking substantive initiatives on fundamental issues such as international monetary system, or coordinating exit policies, while it has been expanding its scope beyond financial sector. Finally, it is argued that it is inappropriate to give the status of a fourth pillar to G-20 since IMF, World Bank and WTO are products of international legal agreements with broad representation, formal governance structures, some accountability, and a permanent secretariat.

In this background, the way forward for G-20 may take one or more of the three possible directions. First, G-20 may emerge as the most important global forum on a continuous basis. However, it should be recognized that as long as the operating arms of the G-20 continue to be the institutions with deficit in governance and a bias in ideology, it will be difficult for G-20 to continue to be effective beyond the crisis period. However, the record of performance so far indicates that G-20 could emerge as a pillar of global economic governance. Second, as the impression of normalcy is restored, the process of G-20 may be diluted to go back to status-quo ante, and thus make G-20 virtually non functional. This had happened before. Third, G-20 may continue in its present form during and beyond the crisis, but may be effectively used in future to undermine the legitimate processes of WTO and United Nations.

4. AGENDA FOR REFORM OF INTERNATIONAL FINANCIAL ARCHITECTURE

There are two possible approaches to reform of International Financial Architecture, viz., a narrow approach or an operations-oriented and a fundamental approach or a strategic approach. A narrow approach would focus on the lacunae that might have been responsible for the crisis in 2008. The second could be a fundamental approach that addresses basic structural problems that tend to create instability and inequity in global economy.

A narrow approach accords importance to surveillance of systemic risks, both at the national and at the global level in the context of existing institutional structures. It also focuses on the importance of coordination of macro economic policies at the national or regional levels, to avoid systemic risks to the global economy. Further, emphasis would

be on deficiencies in the standards of financial regulation at the national level and cross border arrangements in regard to regulation. Finally, it would seek to make available appropriate liquidity for the global economy, particularly whenever external adjustments are needed by countries suffering from short-term liquidity strains. It may be observed that a large part of the initiatives in the G-20 agenda essentially reflect immediate priorities on the operations oriented lines, though good intentions are expressed in communiqués on some strategic aspects. It is not improbable that there is a deliberate choice in G-20 in favour of front loading of consideration of operational issues and back loading of consideration of strategic issues as a more practical sequencing of reforms.

A fundamental view or a strategic view taken on International Financial Architecture, may have to address five important issues. Firstly, there is a need to agree upon an international monetary system that avoids exorbitant privilege to one or few reserve currency issuing countries, and severe disadvantages to emerging market economies and developing countries with current account deficits. Secondly, there is a need to agree upon the mechanisms by which transition to a more viable international monetary system from the current non-system can be brought about. Such mechanisms have significant technical and political implications, in addition to the acceptability to the global markets.

Thirdly, the adequacy of all relevant existing global institutions should be considered in a comprehensive manner, in terms of mandate, governance and policies. These include not only IMF and the World Bank, but also Credit Rating Agencies, the International Accounting and Standards Board, etc. More important, it may be necessary to consider creation of new institutions to fill up the gaps, in particular, for establishing a sovereign debt restructuring mechanisms. The existing practice of disorderly sovereign debt restructuring (except under HIPC initiative) is costly and encourages on occasions, irresponsible lending by the financial markets to the sovereigns.

Fourthly, international coordination of fiscal regimes would be critical for obtaining benefits from and minimizing costs of truly globalised economies. The recent events in Greece indicate the link between fiscal position, monetary independence, and the functioning of the financial markets, including regulation.

Finally, in addition to national level and global institutions relevant to global finance, regional level arrangements such as Chang Mai Initiative are a reality now. These arrangements are still evolving and hence they continue to provide a central role to the IMF for macroeconomic assessment. Over time, the relationship between regional arrangements and IMF will necessarily be redesigned. The global system as it evolves should be rendering greater clarity and importance to the role of regional arrangements in global economic order. In other words, the International Financial Architecture should encompass institutions and policies at national, regional and global level. For example, financial safety nets may be enabled at all three levels, with greater emphasis on national level for larger economies.

5. SOME PERSPECTIVES - NEW REALITIES

G-20 has been playing an extremely important role in moderating the impact of the crisis through global coordination of policies. Secondly, G-20 has been playing an active role in encouraging more responsible macro economic policies through peer pressure. This includes coordination of exit policies in the short run, fiscal sustainability in the medium to long-term, and prudent macro policies in general. Thirdly, G-20 has been emphasizing reforms in regulation of financial sector with focus on enhancing stability, combined with some recognition of developmental objectives, in policies relating to financial sector. Fourthly, efforts are being made to strengthen existing multi-lateral institutions, in particular IMF, and multi-lateral development banks. Finally, G-20 remains an informal body which promotes discussion and an agreement on appropriate actions at national level, and possibly coordination in multi-lateral organizations. A good record of performance so far has been, by and large, in the context of the current crisis, but its usefulness so far provides hope for building on the experience to bring about fundamental changes in International Financial Architecture. More important, there is no credible alternative mechanism in the horizon to take up the task of considering fundamental changes in International Financial Architecture.

In considering strategic approach to changes in global economic order, however, G-20 is yet to take cognizable initiatives. In this regard, some new realities are worth noting. Firstly, emerging market economies, and in particular Asian economies, are critical to bringing about any change in the current state of economic balances or imbalances. Asia accounts for a large part of forex reserves. The EMEs, in particular Asia, have demonstrated a potential for strong economic growth and stability, and increasing share in world output and economic activity. In brief, therefore, any agenda for fundamental changes in International Financial Architecture can be designed and implemented only with active involvement of EMEs especially from Asia. Intellectual inputs to resolve these complex problems will have to increasingly come from the dominant EMEs especially of Asia. The dominant paradigms of economic order are yet to be related fully to successful experience of Asia.

Secondly, the G-3 countries, viz., the USA, Europe and Japan, who have been playing a dominant role in global money and finance will continue to do, but they are exhibiting some weaknesses which cannot be easily overcome in the very near future. USA has persistent current account and fiscal deficits. European Union is grappling with the problems of fiscal coordination and asymmetrical levels of productivity and resilience among the nations. Japan continues to disappoint expectations of revival of growth. Significant changes in their macro economic policy framework would be essential for a suitable and sustainable global economic recovery. A review of the appropriateness of some of the fundamental premises of the policies of G-3 so far should not be ruled out, both in the interest of each of G-3 countries and global economy. Managing public debt and avoiding excess volatility in the movements exchange rate in future are critical to a stable global economy. EMEs, especially Asia may consider taking initiatives on these issues and help set the agenda for reform.

Thirdly, the role of regional arrangements in the reform of international financial architecture is evolving. IMF's participation in the bail-out of Greece sets an interesting precedent. Similarly, participation of EU in G-20 is yet another precedent. There are several agreements of cooperation at regional level which are still evolving and their participation in global forums is unclear.

Fourthly, in seeking global economic coordination and global common policies and standards, the importance of diversity should be recognized. Diversity goes beyond application of a standard approach to the country context and implies possibilities of alternate approaches or divergent assumptions for economic management. It is possible to imagine the damage that could have been inflicted on Asia if during the recent decade a global standard of monetary policy and regulation following the dominant Anglo Saxon model was imposed on all countries in the belief that global coordination warrants such common policy responses. In a sense there is a trade-off between diversity and regulatory arbitrage. The current debate within the G-20 is focussed almost exclusively on the latter without recognising the significance of the systemic importance of diversity. In addition, the current approach seems to ignore the importance of mechanisms at national level, similar to voltage stabilisers and circuit breakers in energy networks.

Fifthly, the balance between finance ministers and central bank governors has been rightly tilted in favour of ministers in view of the compulsions of crisis-management. Exit strategies should perhaps include reconsideration of relative roles of heads of governments, ministers and central bank governors to be consistent with normal times. Sixthly, emerging market economies have been co-opted to the global governance arrangements at informal level through G-20. The extent of their participation, their effectiveness, and their contribution are yet to be demonstrated in a convincing manner. The EMEs would be doing a disservice to themselves and the global economy if they are content with symbolic equality with advanced economies. In particular, China, India, Brazil, Russia, South Africa, and Indonesia have experimented with several models of economic management in a reasonably successful manner and they should be able to bring to the table of G-20 their experiences, perspectives and vision on rebalancing between state and market, between national policies and global order; and between growth and equity, that is underway at intellectual, policy and operational levels.

Finally, it is useful to recognize that India is a low income country in G-20. It has large segments of population below the poverty line. Its share in global trade, or global finance, is among the lowest in the G-20 countries. However, India has a unique position for other reasons. India has not contributed in any way to global imbalance. In the pursuit of its economic policies, particularly financial policies, it did not take extreme ideological positions. It has huge prospects for growth in future. The overall governance structures in the management of the economy are essentially participative. These intangibles give India a position of respectability and credibility, and therefore, influence. However, such influence is most effective only if it is exercised to either introduce new ideas or make a difference to outcomes. The fact that India is a co-chair of Working Group on macro-economic framework is a testimony to the fact that it is already playing this role. Maintaining a position of importance for India in G-20 will require that India remains a source of diversity in thought, participative in process, and interactive in its actions on all major economic issues. In fact, India should project itself as a legitimate voice of many of the countries not represented in G-20, but which are developing and in the process, influence the setting of agenda.