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INTERNATIONAL POLICY ANALYSIS

G-20 Two Years After the Crisis

Back to Business as Usual?

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- Initially, the G-20 functioned as an effective forum for global policy coordination and crisis management. However, the initially successful policy stance has not been maintained and the willingness of governments to engage in global macroeconomic policy coordination and financial system reforms has again weakened. The premature shift to fiscal retrenchment and the tendency for monetary tightening now represent a major risk of a prolonged period of mediocre growth.

- Adapting policies to the perceived need of regaining »financial market confidence« may cause the crisis to get worse. The crisis has shown clearly that the judgement of financial markets cannot be relied upon. Economic reasoning suggests that in the current situation of balance sheet recession, a continuation of expansionary macroeconomic policy has a much better chance than a restrictive fiscal policy to reduce fiscal deficits in the medium term.

- The G-20 has achieved very little in terms of crisis prevention. With regard to speculative activities, financial markets are practically back to business as usual. More than just re-regulation, greater financial stability requires a restructuring of the financial institutions and a rigorous control of financial innovation.

- A globalised economy calls for enlarged and more coherent global economic governance. It will therefore be inevitable to subject exchange-rate and financial policies to multilaterally agreed rules and disciplines, as is the case for trade policies. A reform of the exchange-rate system should allow for sufficient flexibility of nominal exchange-rates to adjust to divergences in monetary developments across countries to curb speculative capital flows, but must also ensure a pattern of real exchange rates that helps to avoid a new build-up of large current account imbalances.

Dialogue on Globalization

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1. Background

The inception of the G-20 goes back to the late 1990s, when the finance ministers and central bank governors of the Group of Seven countries (G-7) – in light of the policy challenges posed by the management of the Asian financial crisis – deemed it appropriate to »broaden the dialogue on keyeconomic and financial policy issues among systemically significant economies and promote co-operation to achieve stable and sustainable world economic growth« (G-20 1999). The Group was thus established as a forum for informal dialogue between advanced and emerging economies to promote international financial stability.[1]

However, until 2008 the G-7/8 remained the main forum for international policy discussion and coordination outside the international organisations. It was unable to prevent the build-up of large current-account imbalances and the resulting threat to international financial stability that emerged in the years preceding the financial and economic crisis that broke out in 2008. It was only when the global dimension of the financial crisis became obvious in the course of 2008 that the G-20 began to take its new role in international economic governance seriously. While some feel that the G-20 has since filled an important gap in the governance structure of the international economic and financial system (G-20 2008:5), others have questioned its legitimacy as the main forum for global economic governance, on the grounds that necessary reforms in global economic governance require the participation of the entire international community (UN 2009:15).

The strengthened role of the G-20 was the consequence of the recognition among a majority of governments that inconsistent and insufficiently coordinated macroeconomic policies had led to unsustainable global macroeconomic outcomes, which were major underlying factors to the crisis. It became clear that the dramatic financial crisis in the developed countries also had serious repercussions on the developing and emerging economies. Even more important was the recognition that the threat of the deepest recession since the Great Depression could not be managed successfully without improved international policy coordination and the involvement of the major emerging-market economies. The Washington Summit on Financial Markets and the World Economy in November 2008 marked the launch of the G-20's efforts to restore global growth and undertake reforms in the world's financial systems to overcome the crisis. With the declaration of their finance ministers and central bank governors in March 2009 (G-20 2009a), the G-20 took the lead in coordinating international policy action to limit the impact of the financial and economic crisis and in launching a reform agenda to prevent similar crises in the future. Its objectives were:

- to rescue the financial system and to limit the depth and length of the recession in the short-term;
- to reduce the risk of financial crises generated from within the financial sector through speculative activities;
- to strengthen the international financial system and reform the international financial institutions to achieve a rebalancing of the world economy and prevent new imbalances.

2. Successful Macroeconomic and Financial Stabilisation

The G-20 reached quick consensus on the need for steps to rescue the financial system from complete collapse after the bankruptcy of Lehmann Brothers. It agreed on the need for governments and central banks to provide strong financial support to the financial institutions that were most severely hit by the financial crisis. This support consisted not only in orthodox measures of expansionary monetary policy, but also comprised unprecedented rescue operations in the form of outright subsidies, recapitalisation or the provision of repayable credit. It also included measures to enable the international financial institutions – in particular the International Monetary Fund (IMF) – to meet increasing needs of member states for external financial support.

The G-20 also supported strong debt-financed demand stimuli to fill the gap created by a sharp drop of private demand for both investment and consumption. The crisis was dramatic enough to lead the G-20 to initiate without hesitation a revival of Keynesian counter-cyclical policies.

1. In addition to the G-7 countries (Canada, France, Germany, Italy, Japan, United Kingdom and United States), the G-20 also comprises Australia and the European Union, as well as 11 emerging-market economies: Argentina, Brazil, China, India, Indonesia, Mexico, Republic of Korea, Russian Federation, Saudi Arabia, South Africa and Turkey.

This unanimous re-orientation of fiscal policy was tantamount to a renunciation of the widespread view that fiscal expansion is generally ineffective – a view that had governed macroeconomic policies for three decades. It was reflected also in declarations of the Managing Director of the IMF and, in some cases, even softened conditionality attached to IMF lending. The policy shift was facilitated by the fact that, distinct from their typical attitude, the main actors on financial markets did not oppose heavy government intervention in this situation, as they depended on it for their own survival.

This turnaround in the macroeconomic policy orientation – and the consistent application of monetary and fiscal stimuli in all major economies – was highly successful in circumscribing the recessionary impact of the financial crisis in 2008/2009 and initiating a recovery in 2010. In their response to the crisis, the G-20 demonstrated a high degree of cohesion in its approach to financial and macroeconomic action, including the emerging countries. Some of them engaged in stabilisation programmes that, in relation to the size of their economies, were even bigger than those introduced in developed countries.

3. Return to Fiscal Orthodoxy and Weakening Coordination of Macroeconomic Policies

The recognition of the importance and effectiveness of fiscal stimulus during the crisis has not been followed up by a more profound rethinking of the principles of macroeconomic policy. Two years after the »Keynesian moment«, many governments have returned to »fiscal orthodoxy«, reversing their policy orientation from one of fiscal expansion to fiscal tightening, and others are planning to do so. This is happening despite a sharp slowdown of growth and a looming new recession. This turnaround is most pronounced in Europe. The United States is continuing with measures to strengthen growth and employment through public investments and tax incentives, and Japan is being forced to raise public spending for reconstruction following the earthquake. Several emerging-market economies and developing economies are also taking further measures to maintain stability and sustain growth by stimulating domestic demand, thus reducing their reliance on exports. The contribution of the emerging-market economies to global growth will increase as these economies move towards more domestically led growth.

When the G-20 finance ministers and central bank governors state that they »are committed to supporting growth, implementing credible fiscal consolidation plans, and ensuring strong, sustainable and balanced growth« (G-20 2011b), this statement is itself lacking credibility for two reasons. First, fiscal retrenchment in the present macroeconomic context in Europe is unlikely to achieve either objective: it will not support growth, nor will it lead to the desired fiscal consolidation, since fiscal sustainability not only depends on the size of the deficit, but also on the growth dynamics of the economy. Second, the macroeconomic – in particular fiscal – policy stances of G-20 members are not well coordinated, and are actually incoherent. This contradiction in the policy approach and the lack of coherence has been reflected in the official statements of the G-20 since the Toronto Summit in June 2010.[2]

Policymakers justify the turnaround in their fiscal stances by pointing to sharp increases in public sector deficits and public debt. However, in light of the continuing weakness of private demand in most industrialised economies, this turnaround must be considered premature. In this situation, maintaining the level of public expenditure – or even raising it – in order to support aggregate demand for goods and services that would secure production and employment would be the logical consequence of the Keynesian re-orientation that marked the G-20 approach at the beginning. This would probably require educating the public about the need for such policies in the present macroeconomic situation.

Clearly, the willingness to engage in global macroeconomic policy coordination is weakening, and disagreement about the further course of macroeconomic policies, especially between the United States, on the one hand, and the European Union, on the other, also weakens

2. This becomes particularly clear in paragraph 9 of the Framework for Strong, Sustainable and Balanced Growth agreed in Toronto – a text that can be easily recognised as the outcome of negotiations among governments with diverging policy stances. It can be read as a justification for any kind of fiscal policy orientation: »We agreed to follow through on fiscal stimulus and communicating ›growth friendly‹ [quotation marks in the original] fiscal consolidation plans in advanced countries that will be implemented going forward. Sound fiscal finances are essential to sustain recovery, [and] provide flexibility to respond to new shocks (…) The path of adjustment must be carefully calibrated to sustain the recovery in private demand. There is a risk that synchronized fiscal adjustment across several major economies could adversely impact the recovery. There is also a risk that the failure to implement consolidation where necessary would undermine confidence and hamper growth. Reflecting this balance, advanced economies have committed to fiscal plans that will at least halve deficits by 2013 (…) Those with serious fiscal challenges need to accelerate the pace of consolidation« (G-20 2010a).

the cohesion of the G-20. This could have negative consequences for potential progress in other areas of the G-20 agenda, notably the stabilisation and realignment of exchange rates.

Moreover, the assumption that an already relatively high public debt undermines the willingness of financial investors to finance the public debt at low interest rates neglects the fact that in most developed economies that were severely hit by the financial crisis, the private sector has not yet completed the de-leveraging process, whereby non-financial agents try to reduce their indebtedness and banks try to restore their capital ratios. It has been pointed out by the chief economist of the renowned Nomura Research Institute that in such a situation of »balance sheet recession«, there are not enough potential private borrowers to translate growing private savings into investment, so that a downward spiral in GDP is likely to result if governments do not act as »borrowers of last resort« (Koo 2010). The multiplier effect of fiscal stimulus on income growth is especially large under these circumstances. In a dynamic perspective, the risk for a deterioration of public finances in the medium and long term is therefore smaller when fiscal policy remains expansionary.

A particular concern in this context is that the return to fiscal orthodoxy is also promoted by the IMF. Despite some rhetoric in favour of counter-cyclical policies at the early stage of the crisis, the IMF is again strongly supporting the austerity programmes being pursued in many countries. This is so despite experiences that show that IMF-sponsored stabilisation programmes systematically underestimate their negative impact on GDP growth and fiscal balances (UNCTAD 2011: 63;IMF and IEO 2003: vii).

Two years after the crisis, restoring the momentum in international coordination of macroeconomic policies to stabilise the global economy remains a serious challenge, as a renewed risk of global recession is becoming acute in the second half of 2011. If surplus economies, such as Germany, again rely on exports for recovery and growth, the burden of providing the necessary demand stimulus is shifted to other countries. Failure to coordinate policies at the G-20 level therefore also raises the prospect of a re-emergence of global imbalances.

The arguments of policymakers in support of a shift to fiscal austerity are typically based on the perception that fiscal consolidationis required to regain »financial market confidence« (see, for example, OECD 2011:8; IMF 2010). This adaptation of policy decisions to certain expectations of financial market behaviour is the result of a widespread perception that markets – in particular financial markets and credit rating agencies – always know better than policymakers what is happening and what is going to happen in an economy. This belief persists despite the recognition that it was irresponsible behaviour of financial market actors that caused the financial crisis in the first place and the resulting need for rescue operations and debt-financed fiscal stimuli. As the renowned Harvard professor Dani Rodrik put it: »If the present crisis gets worse, it will be political leaders that bear primary responsibility – not because they ignored markets, but because they took them too seriously« (Rodrik 2010).

4. A Broad Agenda to Reform Financial Regulation

Attendees of the G-20 London Summit of April 2009 recognised that »major failures in the financial sector and in financial regulation and supervision had been fundamental causes of the crisis« (G-20 2009b). This reflected the general perception that excessive deregulation of financial activities in many countries, notably the Anglo-Saxon countries, had been the root cause of the financial crisis. Several decades of financial liberalisation – and the new financial instruments that came with it – allowed a rapid expansion of speculative activities and excessive risk-taking, with the result that gambling became an important, and at times dominant, feature of financial activities.

Deregulation had paved the way for the emergence of a large »shadow banking system«, particularly in developed economies. By early 2008, the liabilities of that system were almost twice those of the traditional banking sector. Most banks outsourced a large segment of their credit intermediation functions to affiliated companies in a shadow system that was opaque, undercapitalised and largely unregulated. Deregulation also brought about a shift in bank funding, from a reliance on deposits to a greater reliance on capital markets, and a shift from lending to trading activity. Moreover, since the early 1990s, deregulation had accelerated concentration in the banking sector (BIS 2008). This concentration reduced the diversity among financial institutions, as a consequence of which their behaviour became more similar.

All these factors caused an increase in systemic risks. These are risks that arise for the entire financial system from shocks that affect most institutions in the system at the same time – from contagion when individual financial institutions run into difficulty honouring their liabilities, and from spillover effects between different financial market segments.[3] The contribution by large institutions to systemic risk has been found to be far out of proportion to their size (BIS 2009).

The G-20 thus committed »to take action to build a stronger, more globally consistent, supervisory and regulatory framework for the future financial sector, which will support sustainable global growth and serve the needs of business and citizens« (G-20 2009b). This implies that financial regulation reform was considered not only an issue at the national level, but one that also required international cooperation and a degree of harmonisation across countries.

With regard to national financial systems, the G-20 members agreed on efforts to address systemic risks in a more appropriate manner; to extend regulation and oversight to all systemically important financial institutions, instruments and markets; and to extend regulatory oversight to credit rating agencies. The G-20 logically relied on national initiatives, because any changes to regulatory or supervisory arrangements has to come through national legislation that is adapted to the specific needs and circumstances of individual countries.

It is difficult to draw a full picture on the financial regulation reforms undertaken so far at the national level, due to the multitude of aspects and the diversity of the actors involved. In some countries, some reforms have reached the stage of implementation. In the United States, for example, the Dodd-Frank Wall Street Reform and Consumer Protection Act, signed in June 2010, has extended existing regulation to a wider range of financial institutions – including markets for credit derivatives – and imposed new regulations on the trade with such derivatives, forcing these markets to greater transparency. Banks have to spin off their derivative trading, and, more generally, restrictions have been imposed on proprietary trading, that is, trading for their own benefit. The Act also provides for the creation of a council of regulators to coordinate the detection of systemic risks to the financial system. Moreover, it subjects large banks – the so-called systemically important financial institutions (SIFIs) – to enhanced supervision and higher prudential standards. Mergers or takeovers resulting in an institution surpassing more than 10 percent of the total liabilities of the system will be prohibited.

At the level of the European Union, three new supervisory authorities are to be created to oversee and coordinate national supervision of banking, insurance and financial markets. Reforms have improved supervision of credit rating agencies and introduced limits on bonuses paid by banks and investment firms. Reform proposals have also been elaborated with regard to ensuring better transparency and safety in trading in derivatives, regulating hedge funds and regulating the short-selling of financial instruments, including credit default swaps, which had been identified as one factor that aggravated the financial crisis. Moreover, EU legislation on capital requirements has been amended to ensure that all financial institutions have an appropriate level of capital reserves, and guarantees on bank deposits have been increased to better protect savers and prevent bank runs.

While most reform initiatives primarily aim at enhancing regulation of the financial system in its existing structure, in the United Kingdom, where bank concentration is particularly high, the government has decided to break up two large banks, which had been rescued during the crisis through partial nationalization, in an attempt to increase competition. However, regarding the separation of retail banking, where deposits are publicly insured and have to be backed by safe and liquid assets, from investment banking that is inherently associated with high risk, the Independent Commission on Banking has proposed a »structural separation« of activities within existing business groups rather than splitting them up into completely separate corporate entities.

For the elaboration of proposals for reform at the international level, the G-20 mandated the Financial Stability Board (FSB). The FSB replaces the former Financial Stability Forum (FSF), with a strengthened mandate and larger membership, including all G-20 countries.[4] It has assigned specific tasks to other – presumably the techni-

3. For an explanatory discussion of systemic risk, see Kaufmann and Scott (2003).

4. In addition to the members of the G-20, the FSB comprises all members of the former FSF, including Hong Kong, the Netherlands, Singapore and Switzerland, as well as Spain and the European Commission.

cally most competent – international bodies, such as the Basel Committee on Banking Supervision and the organisations setting international accounting standards.

The FSB itself has produced a background note containing some initial proposals to cope with systemic risk and regulatory arbitrage (FSB 2011). The Basel Committee focusses on micro-prudential regulation, which is aimed at circumscribing risk-taking by an individual financial institution, but is also considering precautionary measures related to systemic risk, for instance, higher capital requirements for trading and derivatives as well as for complex securitisations and counter-cyclical adjustments of capital requirements, which take account of the fact that risk associated with a given financial instrument changes over the business cycle. With regard to SIFIs, the Basel Committee has proposed, inter alia, the imposition of higher capital requirements than for other institutions.

5. Slow and Inadequate Progress of Regulation Reforms

Although some progress has been achieved in financial regulation reform, most of the official proposals and initiatives remain to be implemented. Moreover, most initiatives must appear inadequate compared with the costs that insufficiently regulated and highly speculative financial activities have generated for the real economy and the society. Indeed, two years after the peak of the crisis, it appears that financial markets are back to business as usual, and there is a real risk of a new financial crisis. The slow speed of reforms is not surprising because they have to pass through complex consultation and legislation processes, and initiatives are strongly influenced by financial lobbies that have little interest in advancing the reform process, especially in the United States.[5]

An issue that still appears to be far from a solution is the systematic underestimation of risks that arise when all participants in a certain segment of the financial market move in the same direction. Such herd behaviour is typical for financial activities aimed at short-term speculative gains. It results in so-called tail risks, which, while they may occur quite rarely, can have catastrophic consequences when they do (de Grauwe 2007). There had always been a risk that events in the real economy, such as insolvency of a very large debtor or a generalised recession, generate difficulties in the financial sector. However, three decades of deregulation of the financial system have led to a situation where the financial sector, due to its endogenous risk creation, has itself become the main source of risk and instability for the real sector. While this may partly explain the excessive attention that policymakers give to »the markets«, it is not inevitable.

Endogenous risk is created as all participants in today's financial markets dispose of the same information about a few commonly observable events or trends, or on mathematical models that use information of the past in order to forecast the evolution of asset prices. This is why in financial markets the most profitable activities are often derived from following the trends in these markets themselves, no matter whether or not they correctly reflect changes in the underlying variables in the real economy. Acting against the majority – even if this were justified on the basis of accurate information about fundamentals – may result in large losses.

As a result, this herd behaviour moves prices of financial assets. Such herd behaviour is also reflected in the movement of prices of real estate and raw materials traded at international commodity exchanges, as well as exchange rates. When a speculative bubble created by herd behaviour bursts and asset prices suddenly move in the opposite direction, the shock is such that it cannot be absorbed by any capital requirement or liquidity buffer, whatever its size may be. In that situation governments have to step in with rescue packages (UNCTAD 2011:IX).

Regulation that is focussed on the risk that an individual financial institution may become insolvent cannot solve the problem of endogenous risk creation. Therefore, much bolder steps than those proposed so far are necessary to stop gambling in financial markets. One approach envisages measures to re-introduce greater diversity into the financial system through drastic changes in the structure of financial institutions and reducing their size (Haldane 2010).

5. For a recent account of the opposition to financial re-regulation in the United States, see New York Times – Topics, »Financial Regulatory Reform«, 24 September 2011; available at: http://topics.nytimes.com/topics/reference/timestopics/subjects/c/credit_crisis/financial_regulatory_reform/index.html (last accessed on 12.10.2011).

But so far little attention is being given in reform efforts to a more fundamental restructuring of the financial system, like the one undertaken as a consequence of the crisis of the 1930s (UNCTAD 2011: 89 108). A first step in the direction of restructuring could be a clear separation of deposit-taking institutions from those that are engaged in investment banking activities. This could help prevent gamblingby commercial banks. Moreover, publicly owned banks could play a more important role, not only for development finance purposes, but also as an element of diversity and stability.

It is true that a number of publicly owned banks, especially in Germany, were seriously affected by the financial crisis, as their managers had also been contaminated by the »gambling virus« in a context of inadequate internal supervision. But in most countries, public banks have been more resilient during crises, and they have partly compensated for the credit crunch in the private financial system (Demetriades et al. 2009; The Economist 2010). They may also help promote competition in situations of oligopolistic private banking structures.

Following the experiences of the latest financial crisis, the typical arguments against publicly owned banks have further lost credibility. In the midst of the crisis, several large privately owned banks could only survive thanks to public support in the form of additional funding and guarantees. Therefore, it can no longer be argued that publicly owned banks will not operate as efficiently as privately owned banks because they enjoy an advantage through their access to public resources. In principle, as public financial entities do not focus on maximisation of returns, their managers have much less incentive to engage in herd behaviour or exaggerated risk exposure. State-owned banks can also be more directly controlled from the perspective of the public interest, with regard to both the kind of financial activities they engage in and the structure of rewards for their managers.

But in addition to changing the structure of financial institutions as a means to limit speculative activities and excessive risk-taking, consideration also needs to be given to possibilities of controlling speculative financial instruments more directly. Most financial innovations that emerged from financial liberalisation have been serving mainly the financial institutions themselves rather than the greater social interest. Indeed, it is difficult to identify new financial instruments that have been introduced to financial markets in the last two or three decades that have contributed to increasing the efficiency of financial intermediation for the benefit of long-term investment in real productive capacity.

It would therefore be appropriate that a competent public institution carefully examines new financial instruments before their use is authorised. And even after such authorisation is given, the institution would regularly assess their compatibility with stability in the financial system. Newly invented »financial products« would thus be treated in a similar way, as, for instance, new pharmaceutical products, toys or technical devices in most countries of the world: they can only be commercialised once they have passed an examination by a technically competent authority for their potential harmfulness or detrimental side effects. And when their harmfulness is detected only at a later stage, they have to be withdrawn from the market.

Another aspect of financial regulation that has so far been neglected by the G-20 and the FSB is the international coordination of the different national and international proposals and initiatives for financial regulation reform, except the work on capital requirements led by the Basel Committee. It has been suggested that it would be appropriate for the G-20 to strengthen the international dimension of financial regulation through a commonly agreed international financial charter and / or even through the creation of an international institution with tasks similar to those of the WTO in the area of trade (Spaventa 2009; Eichengreen 2008). All countries that seek access for their financial institutions to foreign markets would have to subscribe to a charter or become members of the relevant institution and meet the multilaterally agreed obligations for supervision and regulation. The precise form of that regulation could be tailored to the stage of development and structure of individual country's financial markets. An independent body of experts would decide whether countries are meeting their obligations, and countries not meeting the obligations would face sanctions. Further reasoning in this direction may be inevitable, given contradiction between the high international mobility of capital and the resulting global nature of the financial system, on the one hand, and the national fragmentation of financial regulation, on the other.

6. Reform of the International Monetary System: An Incomplete Agenda

At their March 2009 meeting, finance ministers and central bank governors of the G-20 agreed on the need for reforms to strengthen the global financial system. However, as far as the reforms of the international monetary system and its institutions – in particular the IMF – are concerned, concrete intentions were only spelt out with regard to an increase of their financial resources and their effectiveness and legitimacy. The latter was to be achieved by strengthening the voice and representation of developing and emerging economies in the international financial institutions (G-20 2009a).

As an increasing number of developing and transition economies had to turn to the IMF for financial support to stabilise their exchange rates and prevent a collapse of their banking systems, IMF lending surged after the outbreak of the crisis. In the light of this development, the G-20 in its Global Plan for Recovery and Reform decided that the IMF's resources should be significantly increased. The package included an increase in IMF resources by 500 billion US dollars (to 750 billion US dollars) and a new allocation of 250 billion US dollars for Special Drawing Rights (SDRs).

Although the timetable has not been met, there has been progress in IMF quota and governance reform to strengthen the voice and participation of developing countries in this institution. However, changes in the distribution of quotas and voices had been long overdue and cannot seriously be considered as a reform that was undertaken in response to the crisis. The issue can actually be traced back to the Annual Meetings of the IMF and the World Bank in 2006 (IMF 2006), and long before that the developing country members of the international financial institutions had fought for an increase in their representation (G-24 2004).

There can be no doubt that these adjustments have been long overdue in view of the changing pattern in the world economy with the substantially enlarged share of emerging and developing countries in world GDP, trade and international financial flows. However, they will not by themselves make for a better functioning of the operational activities of the IMF or a re-orientation of its macroeconomic policy, as evidenced in its policy advice and conditionality.

Similarly, the increase in IMF resources related in part to decisions that had already been taken before the crisis. Moreover, the additional SDRs have been allocated to IMF members according to their quotas, so that only a minor part of the new SDR allocation directly benefits low- and middle-income developing countries, which are most in need of international liquidity. Improving the potential for multilateral financial support can, in principle, help developing and emerging economies to counter the impact of shocks resulting from an unfavourable external environment. However, such support could have been made considerably more effective if it had been linked to a review of the principles that guide the policy conditions attached to IMF lending. In past crises, those conditions had often deepened crises in borrowing countries.

Given the importance of exchange rates for stable and sustainable international trade and financial relations, the major shortcoming of the G-20 process, so far, has been the lack of determination to launch a reform of the international exchange-rate system. The issue of a reform of the international reserve system and the exchange-rate system was not an explicit G-20 topic at the outset. It has only been since the Seoul Summit in November 2010 that the issue of exchange rates has been regularly addressed in G-20 communiqués. The Seoul Action Plan acknowledges that vigilance against excess volatility and disorderly movements of exchange rates, including those of reserve currencies, »will help mitigate the risk of excessive volatility in capital flows facing some emerging countries« (G-20 2010b).

Although the G-20 has acknowledged that »excess volatility and disorderly movements in exchange rates have adverse implications for economic and financial stability« (G-20 2011b), exchange rates continue to be disconnected from macroeconomic fundamentals and are primarily determined by capital in- and outflows that are motivated by the possibility of gains from currency speculation. The commitment in the Seoul Action Plan to »enhance the stability of financial markets, in particular moving toward more market determined exchange-rate systems, enhancing exchange rate flexibility to reflect underlying economic fundamentals« is a contradiction in itself: experience has shown that purely market-determined exchange rates mostly do not reflect underlying fundamentals and may contribute to instability in financial markets (see also Flassbeck 2001).

7. Need for Greater Coherence in Global Economic Governance

A new global financial crisis with perhaps even more dramatic repercussions on growth and employment in the world cannot be prevented by reforms of national financial systems alone. This also requires greater coherence in global economic governance, including international surveillance and coordination of national financial regulation; a review of IMF policy orientation and the role of the SDR; and, in particular, a framework for exchange-rate management. While the World Trade Organization provides a multilateral framework for international trade relations, there remains an institutional vacuum for monetary and financial policies and international financial relations.

Trade liberalisation within a system of multilaterally agreed rules is often understood as key to faster growth and development. Although the actual and potential gains of multilateral trade liberalisation for growth may often be exaggerated and existing trade rules may not always be appropriate for all countries, there can be no doubt that the existence of such rules, regulation of exceptions from such rules and dispute settlement procedures contribute to greater stability and predictability in international trade.

By contrast, the absence of multilateral rules and disciplines in international monetary and financial relations implies a high degree of uncertainty for international trade. Large exchange-rate fluctuations and persistent misalignments can have much stronger negative effects on international trade than the positive effects that may have been achieved in many years of negotiations on the reduction of tariffs and others barriers to trade.

The reform of the international monetary system has often been discussed from the point of view of replacing the US dollar as the major reserve currency. There may be good reasons to reflect about alternatives to the current dollar-based reserve system, especially by strengthening the role of the SDR as a reserve medium and denomination of international liquidity that could be created by the IMF (UN 2009; Akyüz 2010). This could reduce the need for countries to hold foreign exchange reserves and ensure greater stability in the value of such reserve holdings. However, it would not solve the problem of exchange-rate determination among the individual countries and of each currency to the SDR.

8. Towards a Multilateral Framework of Exchange-rate Management

Experience has shown that neither fully flexible (»market determined«) nor completely fixed exchange rates can work in a world where inflation rates or changes in unit labour costs differ considerably across countries. Leaving currencies entirely to market forces entails considerable risks that speculative herding distorts external trade. Fixed exchange rates, on the other hand, do not allow for adjustments in light of inflation and labour cost differentials.

The United Nations Conference on Trade and Development (UNCTAD) has made a proposal that appears to come very close to solving the problem of reducing international financial and currency speculation and avoid trade-distorting currency misalignments. It envisages a system of managed floating that follows certain rules for keeping the **real** exchange rate stable at a level consistent with a sustainable current-account position, while allowing for regular and predictable adjustments in the **nominal** exchange rate (UNCTAD 2011).

Under such a system of »rules-based managed floating«, central banks would play an active role in determining the exchange rates. They would cooperate with other central banks of the system, ensuring the necessary intervention in currency markets, possibly with appropriately enhanced multilateral surveillance by the IMF. Central banks would act to adjust nominal exchange rates either in response to changes in purchasing power parity or to differences in short-term interest rates.

The former principle is focussed directly on the trade effect of movements in the real exchange rate: it implies a smooth adjustment of nominal exchange rates to the difference between the rate of inflation of a country and its main trading partners.[6] The loss of competitiveness experienced by the domestic producers as a result of higher domestic costs of production would be compensated by a currency devaluation, preventing the emergence of a trade imbalance and the resulting accumulation of external debt. There are various possibilities for the relevant measure of inflation, but unit

6. For example, if inflation is six per cent p.a. in one country and three per cent in its trading partners, the nominal exchange rate would be devalued by three per cent, so that the purchasing power parity would be maintained.

labour costs appear to be the most appropriate measure for domestically generated inflation because they exclude the impact of import price changes or changes in primary commodity prices that are not determined by domestic macroeconomic conditions but in international commodity exchanges.

Adjusting the nominal exchange rate to interest rate differentials affects international competitiveness and trade flows indirectly. The focus here is on avoiding destabilising speculative capital inflows resulting from interest rate differentials, which, without central bank intervention, would cause a revaluation of the nominal exchange rate and shifts in the international competitiveness of producers in the different countries (Bofinger and Wollmershäuser 2000). In this case, nominal exchange rates would be adjusted to changes in the short-term money-market rate; since the latter is closely related to the interest rate set by the central bank and, thus, the rate of inflation, the outcome of applying either of the two principles would in most cases be quite similar: real exchange-rate misalignments resulting from cross-country differences in the evolution of unit labour costs or from an appreciation of the nominal exchange rate as a result of speculative capital inflows could be avoided.

This would provide a considerably more stable environment for production and investment decisions by all actors in tradable sectors. It is also important to note that incentives for speculative capital flows would largely disappear. As a side-effect, it would reduce the need for holdings of large amounts of foreign exchange reserves, as the risk of speculative attacks or external debt crises would be substantially reduced.

A proposal by UNCTAD along these lines has been considered in the context of the G-20 Mutual Assessment Process (G-20 2011a). Especially the emerging-market members of the G-20 should have a keen interest in a reform of the exchange-rate system, since many of them have suffered greatly from the inadequacy of the current non-system. Clearly, there are a number of challenges in establishing such a system and making it operational, such as the determination of the initial parities that are supposed to reflect purchasing power parity and are consistent with a sustainable current account balance. The latter may differ according to the particularities of each country. The system is best suitable for countries with a fairly developed manufacturing and/or service sector, since trade in manufactures and services is likely to be more sensitive to changes in labour cost differentials than trade in primary commodities. For these countries the »equilibrium exchange rate« to be targeted within the system of rule-based managed floating will in most cases be the rate that generates a balanced current-account. In the case of a country with a large share of primary commodities in its exports, it has been suggested to maintain the real exchange rate at a level that ensures balance in the manufacturing trade balance (Bresser-Pereira 2011).

Clearly, a system of rule-based managed floating, as proposed by UNCTAD, is unlikely to materialise at the global level any time soon, since so far the most influential members of the G-20 are lacking the political will to engage in launching any comprehensive review of the international exchange-rate system. Meanwhile, rule-based managed floating with symmetric intervention could become a key element of bilateral or regional monetary cooperation between countries that are main trading partners for each other.

In the absence of a profound reform of the exchange-rate system, the G-20 could contribute to achieving greater stability and economic rationality in international capital flows by furthering consensus-building over an international financial transaction tax that would reduce the potential for speculative gains by making short-term international capital movements more costly. The idea of such a tax goes back to a proposal made by James Tobin in 1978 (Tobin 1978). Various kinds of such a tax have been discussed as serious policy options – especially after the Asian financial crisis in the late 1990s – and one variation is now being officially proposed by France, with the support of the European Union, for endorsement by the G-20. The G-20 could also encourage the IMF to play a more constructive role in helping countries to protect themselves against undesirable speculative capital flows by various forms of capital controls, not only by tolerating such controls under certain conditions, but even by inciting governments to introduce such controls in connection with its surveillance function.

9. Conclusion

While the G-20 initially led a successful re-orientation of macroeconomic policies, two years later serious downside risks remain, as the initially successful policy stance has not been maintained and the willingness to engage in global macroeconomic policy coordination has evaporated. The premature shift to fiscal retrenchment and the tendency for monetary tightening represent a major risk of a prolonged period of mediocre growth in developed economies.

With regard to institutional reform, at least two important tasks are far from being accomplished: first, to reduce the scope for the financial sector to endogenously generate risks for the real economy and to ensure that the financial sector fulfils its main economic role – the provision of finance for real productive investment; second, to initiate a fundamental reform of the international exchange-rate system.

Membership of a number of emerging economies in the G-20 does not seem to have led to significantly different outcomes than during G-7/8 processes. However, it has ensured that greater attention is being given to developing countries' concerns in global economic policy-making. A first result is that the G-20's Mutual Assessment Process has led to a dismantling of the previous quasi-monopoly of the IMF in the provision of analysis and technical expertise and greater plurality in analytical approaches and policy recommendations, through the inclusion of organisations such as the ILO, UN and UNCTAD, which are known for their scepticism towards any market fundamentalism. Moreover, membership of emerging markets can probably do much more for changing the orientation of global economic governance than the more cosmetic changes that have sought to include the voice and participation of developing countries in the international financial institutions.

In the most dramatic phase of the crisis, the G-20 functioned as an effective forum for global policy coordination, despite the doubts with regard to its legitimacy. However, so far it has achieved very little in terms of crisis prevention. A number of critical issues remain, which, in the current global institutional setting, can be effectively addressed by an international body like the G-20, provided that all members realise that improved global governance is in their best national interest.

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