



RESHAPING GLOBAL
ECONOMIC GOVERNANCE
AND THE ROLE OF ASIA
IN THE GROUP OF TWENTY (G20)



Reshaping Global Economic Governance and the Role of Asia in the Group of Twenty (G20)

**Prepared under Asian Development Bank's Technical Assistance 7501
"Asia's Strategic Participation in the Group of Twenty
for Global Economic Governance Reform"**

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Foreword

The global financial and economic crisis left in its wake important lessons we cannot ignore. Any return to strong, sustainable, and balanced global growth will require an ambitious, broadly shared and supported plan for structural reform and its implementation.

Two important and fundamental changes are taking place in the post-crisis world. First, the crisis prompted unprecedented policy coordination across borders and continents to build a collective response—not just between large, advanced economies, but with strong participation from emerging market economies. This rise of emerging market economies heralds a significant change in the global economic and political order. Second, the crisis greatly undermined the concept of self-regulating free markets, which has long dominated the world of finance. The crisis has generated meaningful critiques of such an approach and, in response, a new wave of globalization will likely take place in a more flexible and multipolar fashion.

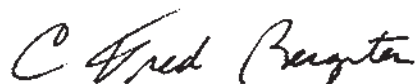
A new foundation is needed to resume economic development and growth—one based on resolving four central global issues. First is an orderly resolution of global imbalances. With economic recovery varied in depth and speed, global imbalances are again on the rise, posing a threat to the sustained recovery. Second is strengthening the global financial architecture to safeguard financial stability, more so because the impetus for reform is weakening as the urgency of the crisis fades. Already, efforts to reform distressed financial systems in advanced economies have encountered strong resistance. Third, the global economic governance system should be more inclusive, to better reflect new emerging economies. While the broader G20 has replaced the G7 as the world's premier forum for economic cooperation, it has yet to provide effective global economic governance. And finally, economic growth and development must be made sustainable.

With the policy focus shifting from crisis responses to systemic management of the post-crisis economy, the G20 is now taking responsibility for steering reforms to achieve sustained and balanced growth for all while safeguarding global financial stability.

With strong, robust economies, Asia is well-positioned to assume its G20 responsibilities and take the lead in the inevitable global rebalancing process. This report is designed to provide strategic guidance for Asian members of the G20 to forge a strong regional position on global issues. By

doing so, they can make a substantive contribution to sustained and balanced growth for the world while ensuring the region's development challenges and priorities are met.

Without tighter coordination, particularly between traditional and emerging economic powers, we will fail to preserve the development gains of the recent past, let alone finding any lasting solutions to pressing global problems. Drawing on the experience and knowledge of both the Asian Development Bank and the Peterson Institute for International Economics, this report will provide essential guidance for building a cooperative and coherent economic framework that supports and promotes sustained and balanced growth for all.



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This report is an outcome of the Asian Development Bank's (ADB's) Research and Development Technical Assistance project 7501, *Asia's Strategic Participation in the Group of Twenty (G20) for Global Economic Governance Reform*. The project was conceptualized, supervised, and coordinated by Cyn-Young Park under the overall guidance of Iwan Azis, Head of ADB's Office of Regional Economic Integration.

The report, jointly prepared by ADB and the Peterson Institute for International Economics (PIIE), draws on important lessons from the global financial crisis to offer policy recommendations in the areas of growth, finance sector reforms, international financial institution reforms, the link between global and regional financial institutions, global financial safety nets, trade, development, and energy and climate change. It also highlights the importance of Asia's active participation in global policy dialogue and reform initiatives. A team of PIIE research fellows led by Marcus Noland prepared background papers on key economic governance reform and policy issues while Cyn-Young Park coordinated similar efforts from ADB and other regional scholars. The contributors to these background papers include Douglas Arner, Iwan Azis, Taeho Bark, Yoon Je Cho, Joseph Gagnon, Morris Goldstein, Gary Hufbauer, C. Randall Henning, Trevor Houser, Moon Sung Kang, Jacob Kirkegaard, Cyn-Young Park, Edwin Truman, and Woan Foong Wong.

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Abbreviations

ADB	Asian Development Bank
ASEAN	Association of Southeast Asian Nations
ASEAN+3	Association of Southeast Asian Nations Plus Three
CMIM	Chiang Mai Initiative Multilateralization
DFQF	duty-free quota-free
EU	European Union
FCL	flexible credit line
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FTA	free trade agreement
G7	Group of Seven
G20	Group of Twenty
GFC	global financial crisis
GDP	gross domestic product
IEA	International Energy Agency
IFI	international financial institution
IMF	International Monetary Fund
LDC	least developed country
MDB	multilateral development bank
OECD	Organisation for Economic Co-operation and Development
PCL	precautionary credit line
PIIE	Peterson Institute for International Economics
PRC	People's Republic of China
SDR	special drawing right
UN	United Nations
UNFCCC	UN Framework Convention on Climate Change
US	United States
WTO	World Trade Organization

Highlights



Faced with the most serious global financial crisis since the Great Depression, in November 2008 the Group of Twenty (G20) initiated a series of summit meetings to address the critical issues confronted by the global economy. The November 2010 Seoul G20 Summit marked the first time that the group was convened by an Asian or non-Group of Seven (G7) host. This report addresses the extensive set of challenges on the G20 agenda, reflecting both ongoing issues from previous summit meetings and new challenges that confronted leaders in Seoul.

The report begins with a consideration of the G20 Framework for Strong, Sustainable, and Balanced Growth, followed by discussions of finance sector reform, reform of the international financial institutions, the relationship between regional initiatives and the global financial architecture, global financial safety nets, trade, development, energy and climate change, and a section on the perspectives of Asia's emerging economies.

The key findings can be summarized as follows:

- External imbalances appear to once again be growing, and increased exchange rate flexibility in large-surplus countries is a necessary, though not sufficient, component of balanced adjustment.
- While the strengthened bank capital and liquidity requirements announced by the Basel Committee on Banking Supervision are welcomed, additional work at the multilateral and national levels is advisable.
- There is a broad need to strengthen existing institutions under stress; an increase of International Monetary Fund quota resources from \$250 billion to \$500 billion was agreed, but this is to be accomplished without increasing its total available resources because the size of the New Arrangements to Borrow will be reduced proportionately.
- A group of "Trade Wisemen" should be created to establish an "I know it when I see it" doctrine against new protectionism, which would act as "name and shame" enforcers of the open economy pledges made by G20 leaders and commend countries that unwind prior protectionist measures.

- While there is little scope at present for the G20 to take on climate change diplomacy, it can do a great deal to advance climate change action. The existing G20 agenda has the potential to reduce global emissions, accelerate the deployment of clean energy technology, and mobilize public and private finance for mitigation and adaptation.
- The new global economic governance structure needs to reflect the changing economic weight of emerging economies in the global economy. Asia should and will play a greater role on the global stage—for example, shaping the G20 agenda for balanced and sustainable growth through strengthening intraregional trade and stimulating domestic demand.

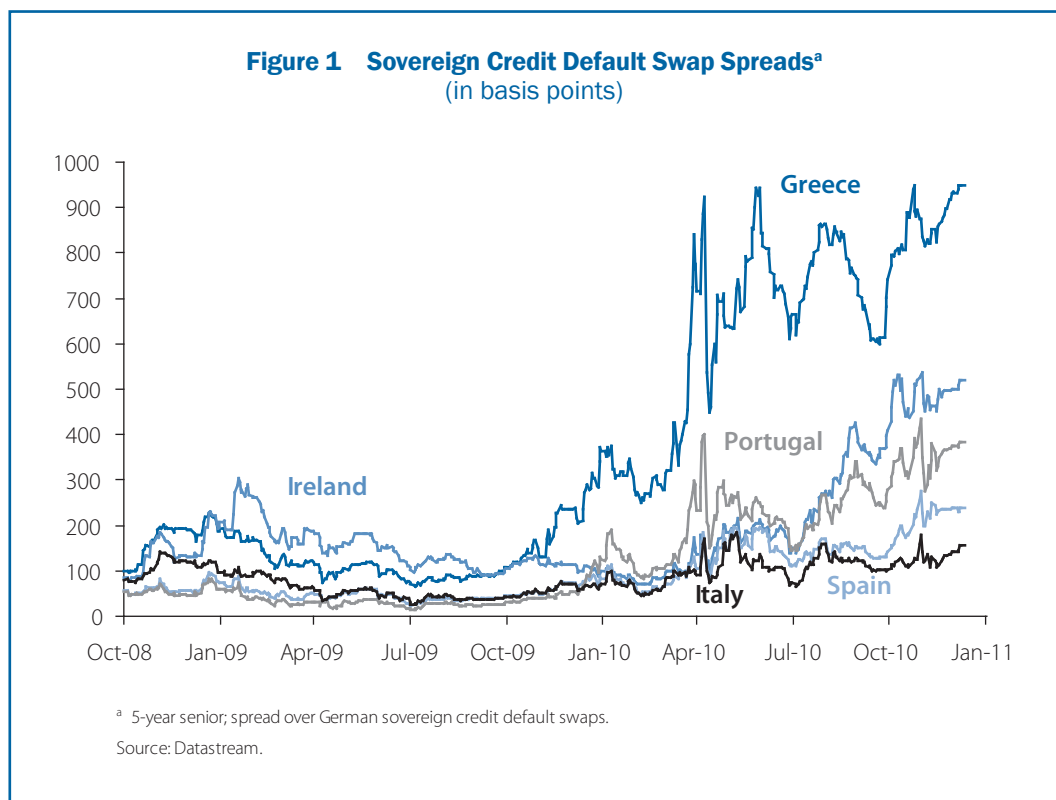
Framework for Strong, Sustainable, and Balanced Growth

At the September 2009 Pittsburgh Summit, leaders of the Group of Twenty (G20) announced the Framework for Strong, Sustainable, and Balanced Growth. They committed to undertaking macroeconomic policies to pull the world economy out of recession and to submitting their actions to peer review, aided by the International Monetary Fund (IMF). The Seoul Summit marked the one-year anniversary of the formal launch of the initiative in November 2009 by finance ministers and central bank governors.

At the June 2010 Toronto Summit, the first stage of the mutual assessment process was successfully completed. This involved macroeconomic assessments by the IMF and the development of policy options for groups of countries. Building on this outcome, the leaders committed to an ambitious set of goals that included the need for some high-income countries to implement growth-friendly fiscal consolidations, for countries with large current account surpluses to focus on domestic demand-led growth, and for all countries to undertake structural reforms to raise their growth potential. A key aspect of the transition from Toronto to Seoul was the G20 “taking ownership” of the process, working with the IMF to develop forecast scenarios and policy options at the country level.

In taking ownership, the group faces a number of challenges. First, there is considerable uncertainty about the future trajectory of the global economy. While economic performance has generally improved from the depths of 2008, there is significant variation among the G20 countries in the pace of recovery. This implies that the individual G20 countries now face different policy priorities, unlike the beginning of the crisis when they shared the urgency of crisis. Conflicts of national interests could delay the progress of the G20 agenda and present hurdles in reaching new agreements.

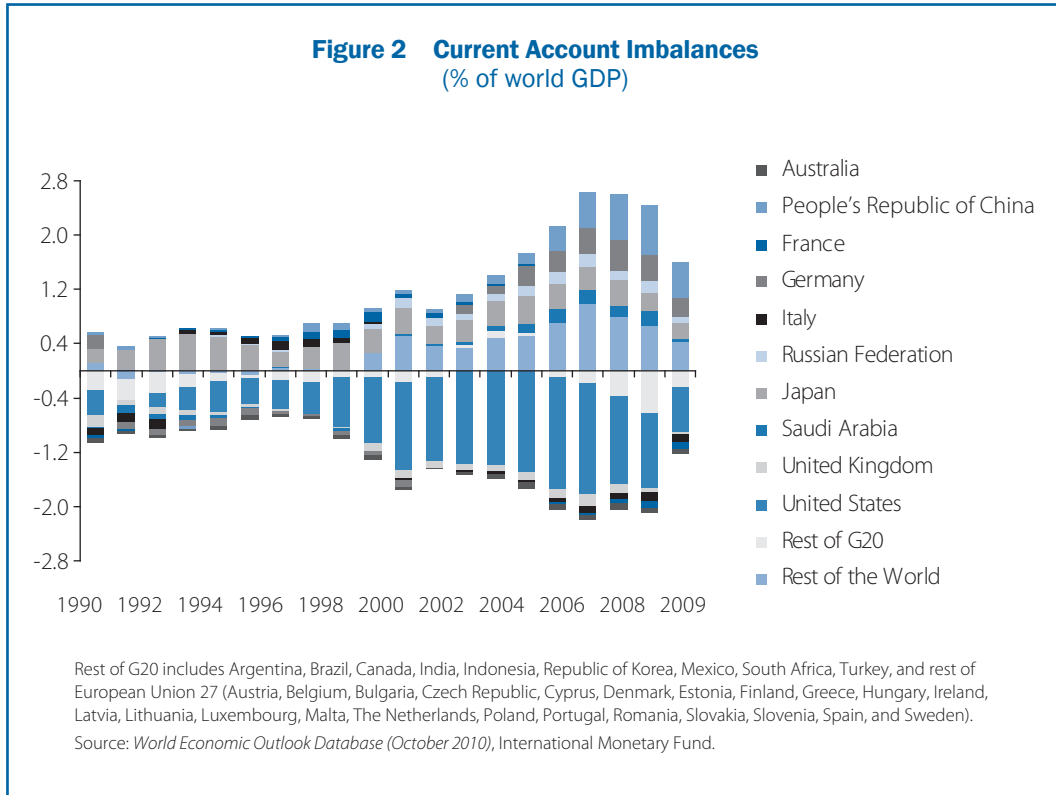
Second, adverse developments in some European sovereign debt markets continue to test the G20 commitments to restore fiscal sustainability (**Figure 1**). There is ambiguity about the advisable fiscal stance of some G20 governments, which has emerged as a subject of controversy both at the domestic and international levels, partly due to analytical differences



about the likely response to short-run changes in fiscal policy. At the Toronto Summit, the G20 committed to fiscal plans that would at least halve their fiscal deficits by 2013 and stabilize or reduce government debt-to-gross domestic product (GDP) ratios by 2016.

What is clear is that some of the rich G20 countries face significant long-run fiscal challenges associated with publicly financed pension and health care costs. And whereas there is broad consensus in the G20 about the desirability of reining in long-term social expenditures, there is less consensus with regard to advisable short-term fiscal policy, characterized by Changyong Rhee (2010) as a debate between “cutters”—who believe that the improvement in confidence associated with short-term fiscal consolidation would induce sufficient private sector activity to more than fully offset the fiscal drag—and the “postponers”—who adhere to more traditional Keynesian notions of short-run demand management.

The textbook solution would be to combine short-run fiscal expansion with a long-term commitment to fiscal consolidation. The problem is that such commitments may not be politically credible, creating the conundrum in which the G20 currently finds itself. Whatever the specific merits of each position, it is important that the G20 governments continue to commit themselves to *policies* over which they exert control and not to *outcomes*, which they influence only imperfectly.



A third challenge is the reemergence of widening external imbalances, which many observers believe contributed to the financial crisis and now threaten the “balanced” aspect of the Framework for Strong, Sustainable, and Balanced Growth. Current account imbalances reached record levels before the financial crisis of 2008–2009 (**Figure 2**). As economies contracted during the crisis, the imbalances narrowed considerably, but they remain historically large. Several factors seem to have contributed to the persistently large payment imbalances.

- First, fiscal policies are important drivers of current accounts in both advanced and developing economies. Joseph Gagnon (2010) demonstrates that fiscal balances are more important drivers of current account imbalances than previously thought. The current account tends to increase by 20%–30% of any increase in the fiscal balance, whereas previous research found an effect of 10%–20%. Fiscal deficits are expected to be larger in the next 5 years than they were before the financial crisis in many economies with current account deficits. Based on these statistical results and on policy plans that have been announced to date, current account imbalances are likely to return to record levels over the next 5 years. This conclusion supports the view that the recent narrowing of imbalances was almost entirely a result of the global recession and that global recovery will unwind this effect. Indeed, the most recent data for some of the largest G20 economies suggest that IMF forecasts for current accounts substantially

- understate the likely rebound in imbalances in 2010. This result also reinforces the Toronto Summit call for fiscal consolidation in economies with current account deficits.
- Second, external financial policies are also important drivers of current account imbalances in developing economies, although their impact on these imbalances is relatively limited in advanced economies. These policies include, for example, preventing exchange rate appreciation after positive shocks to net exports by sterilized intervention in foreign exchange markets. Such policies enable current account balances to remain positive indefinitely because they shut off the normal adjustment channel of real exchange rate appreciation. These policies are more common in developing economies than in advanced economies, in part because greater capital mobility in advanced economies makes sterilized intervention less effective.
 - Third, economies with persistent current account surpluses tend to build their stocks of net foreign assets, and these net asset positions tend to increase current account surpluses further through positive net income flows.
 - Fourth, changes in oil prices and production also have important effects on current account balances. Other factors, such as demographics and stage of development, are not robustly associated with current accounts.
 - Finally, alternative approaches to projecting current accounts, based either on historical trade elasticities or estimates of the Balassa–Samuelson effect, show that if real exchange rates are held constant over the next 5 years, current account imbalances are likely to widen considerably. Greater exchange rate flexibility in developing economies, and thus reduced net official financial flows, would go a long way toward reducing imbalances in developing economies with current account surpluses. The counterpart to this adjustment would be an increase of current account balances in the advanced economies that have been the recipients of official flows from these developing economies. For the United States (US) and the United Kingdom, which have current account deficits, the result would be a reduction in imbalances. But for Germany and Japan, which have current account surpluses already, the result would be a widening of imbalances.

Looking ahead, these underlying factors driving the current account imbalances, such as fiscal deficits, stocks of net foreign assets, and exchange rate misalignments, are unlikely to reverse their course and are projected to strengthen even further over the next 5 years in many economies, suggesting that even larger imbalances are on the way. Stocks of net foreign assets have increased in many economies with a current account surplus while real exchange rates are not expected to adjust significantly, despite large differentials in economic growth rates. The main exceptions are the oil-exporting economies, notably the Russian Federation and Saudi Arabia, which are ramping up plans to spend elevated oil earnings over the medium term.

If real progress is not made on persistently large international payment imbalances, prospects for a sustainable global recovery will diminish. To avoid a return of large global imbalances,



economies with current account deficits should cut fiscal deficits more than they are currently projected to, and economies with current account surpluses should reduce official financial outflows and allow their currencies to appreciate.

However, the postcrisis recovery remains fragile and country-specific circumstances need to be taken into account when considering the policies to reduce large global imbalances. Fiscal consolidation in surplus economies—though necessary in some cases—is detrimental to rebalancing and should proceed at a slower pace and to a lesser degree than in deficit economies. Monetary policy should remain accommodative and even ease further in economies where output remains below potential and inflation threatens to fall below desired levels. Structural reforms to boost long-run growth and rebalance domestic savings and investment should be encouraged, but the specifics of these reforms differ across countries and it is difficult to predict the size and timing of their effects.

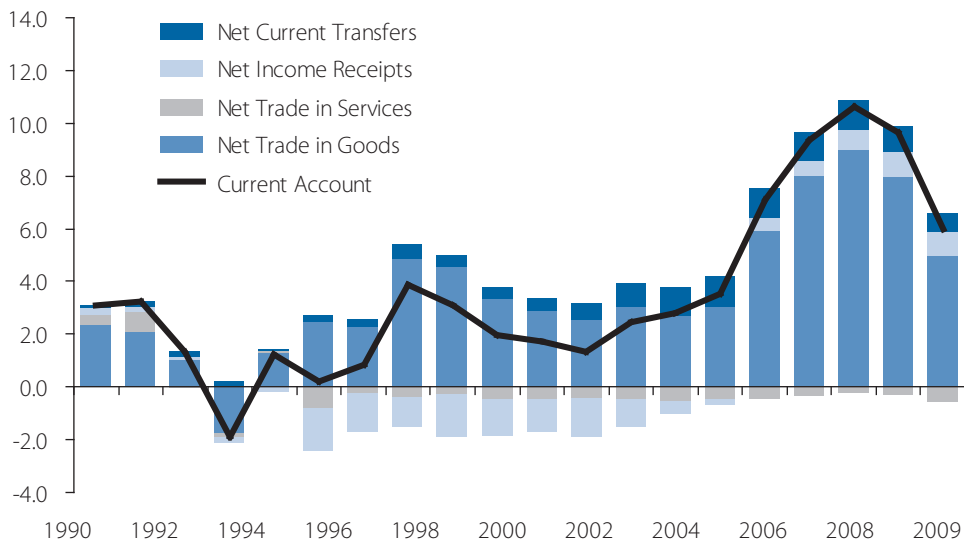
The prospects of speedy external rebalancing remain cloudy unless further collective actions are taken. One of the key concerns is significant currency misalignment. Exchange rate adjustment is an essential element for global rebalancing. While there has been visible progress toward increased exchange rate flexibility in emerging market economies with current account surpluses, some large emerging market economies appear to be reluctant to allow any sharp adjustment in their exchange rates for various reasons, including the fear of losing export competitiveness. Meanwhile, these emerging market economies, especially in Asia, continue to post large surpluses and accumulate foreign exchange reserves (**Figures 3, 4, and 5**).

The IMF's mutual assessment process offers useful guidelines for further collective actions to reduce global imbalances. In its report to the G20 prior to the Seoul Summit (IMF 2010b), the IMF provides an assessment of the G20 policies and emphasized benefits of collaborative action toward global rebalancing. Priority areas include a gradual reduction of public support and further fiscal consolidation in advanced economies; greater exchange rate flexibility to shift demand from external to internal sources in surplus emerging market economies; and structural reforms in product, services, and labor markets to enhance productivity.

Persistently large global imbalances associated with significant currency misalignment and the lack of mechanisms to correct it points to a huge hole in the international monetary system. It is generally much less costly, both economically and politically, for current account surplus countries to maintain the surpluses and accumulate reserves than it is for deficit countries to sustain deficits. Deficit countries must either run down their reserves or deflate their currencies, while surplus countries can simply accumulate reserves. Reserve accumulation can go on forever, seemingly depending on the openness of the financial system and the degree of sterilization. Such an asymmetric adjustment process tends to delay a rebalancing of the international reserves. Meanwhile, there is no workable, graduated set of penalties for countries that refuse persistently to adjust their macroeconomic and exchange rate policy—particularly if

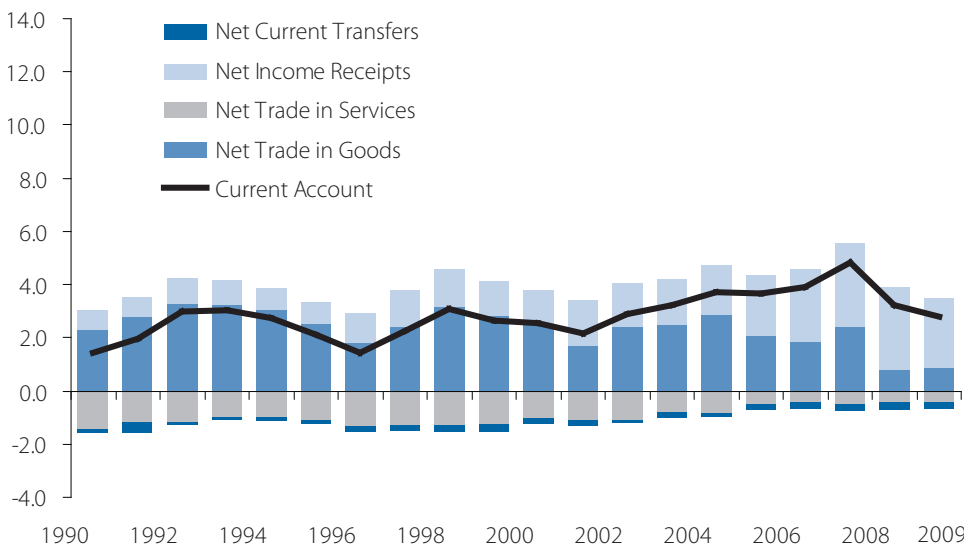
Figure 3 Current Account Composition
(% of GDP)

a) People's Republic of China



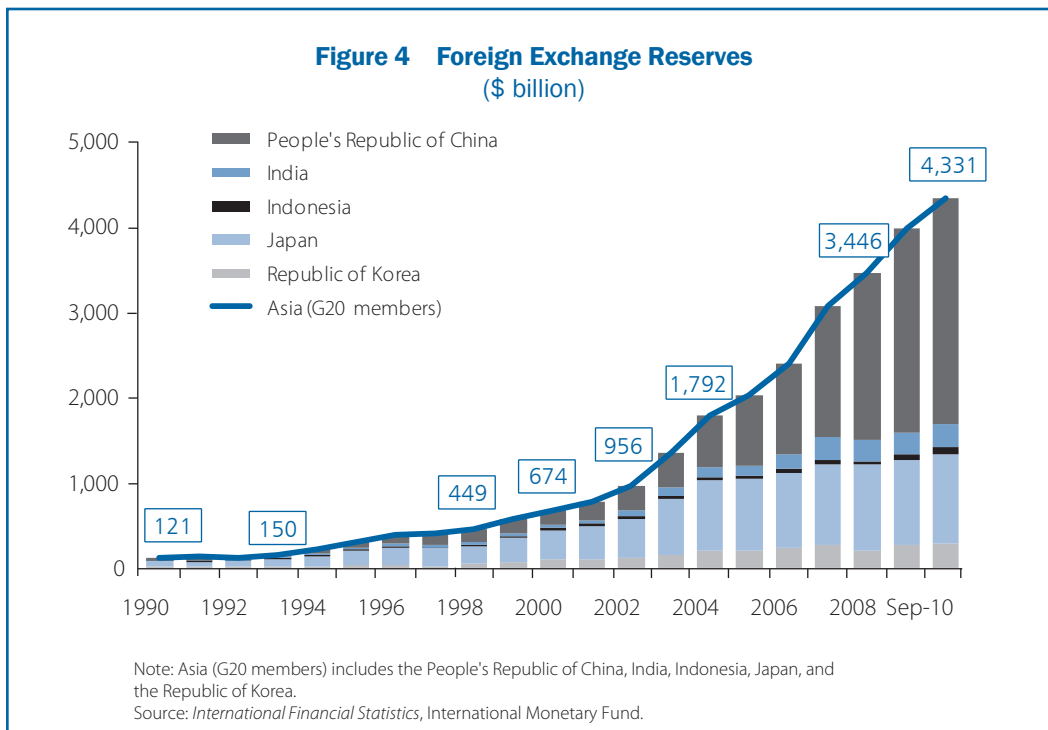
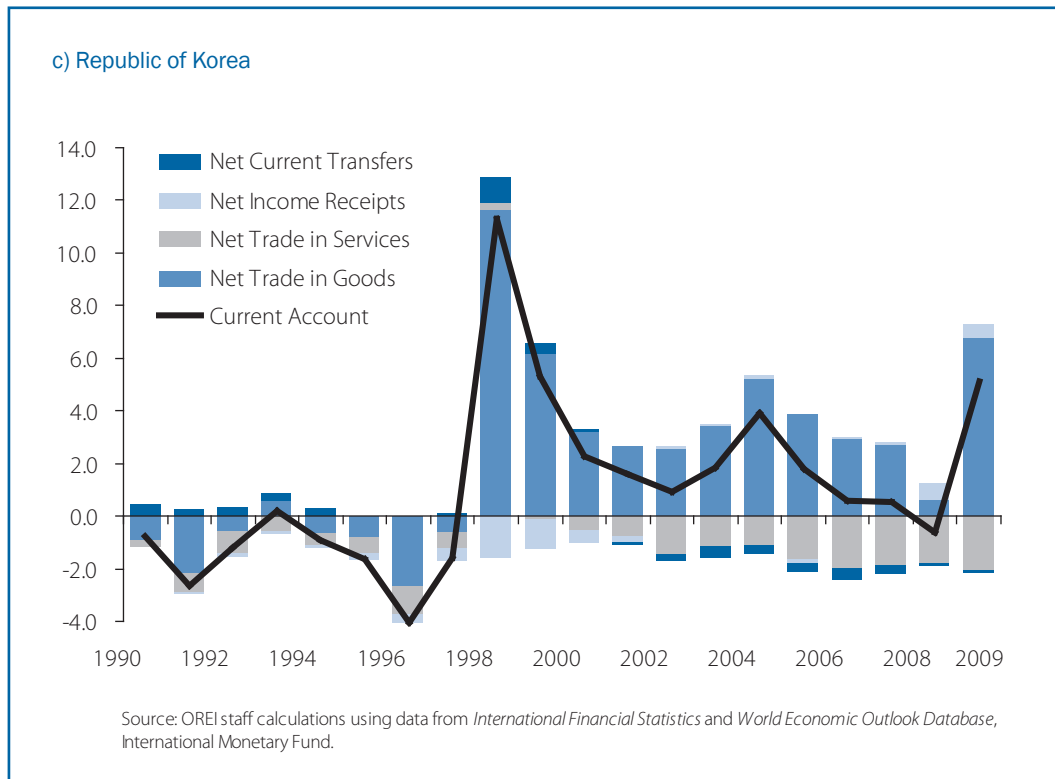
Source: OREI staff calculations using data from *International Financial Statistics* and *World Economic Outlook Database*, International Monetary Fund.

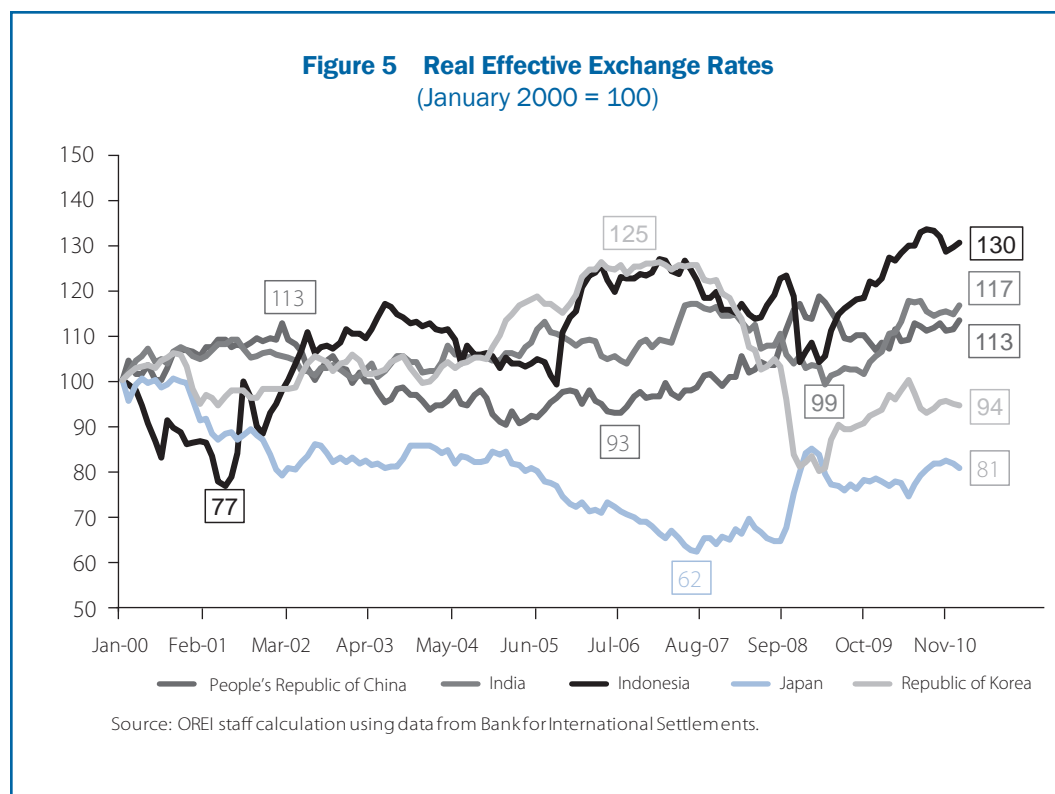
b) Japan



Source: OREI staff calculations using data from *International Financial Statistics* and *World Economic Outlook Database*, International Monetary Fund.

Figure 3 continued





they are large economies with current account surpluses. There has to be some credible penalty in the middle between the IMF's opinion on macroeconomic and exchange rate policy (easily dismissed) and expulsion from the IMF for not honoring obligations under Article IV (too drastic to be useful).¹

A fourth and related challenge is the reform of the global monetary and reserve system. Evaporation of international liquidity during the crisis was a strong reminder of the frailty of the existing international monetary system. International reserves remain highly concentrated in a few holders—the top five countries hold nearly half. Reserves are also concentrated in one currency, with the US dollar accounting for about three-fifths. While the global economy is becoming increasingly multipolar with the rapid rise of emerging market economies, the international monetary and reserve system has yet to adjust.

Many Asian economies have contributed to this imbalance by pursuing export-oriented growth strategies, supported in part by undervalued currencies. By having persistent current account surpluses and accumulating the reserves, Asian economies have traded exchange rate stability

¹ Morris Goldstein (2010) offers such a set of graduated penalties.



for exposure to large capital losses if the US dollar were to suddenly depreciate. However, as the share of emerging Asian economies in global economic activity grows, delayed adjustment would be self-defeating. Policy decisions in emerging market economies are now pivotal for the stability of the global monetary and financial system, and ultimately global economic growth and stability. Such inevitable and rapid structural changes need to be fully reflected in new global monetary and financial governance.

Reforms at the IMF and other international financial institutions to increase the size of financial safety nets should reduce the incentive for economies to build large foreign exchange reserves and other official assets. In principle, this could help to narrow current account imbalances associated with large net official financial flows. Various proposals for global safety nets have been put forward, including a new precautionary credit line and for liquidity assistance to regional financing arrangements introduced by the managing director of the IMF (Strauss-Khan 2010).² The government of the Republic of Korea also made a proposal for extending the system of official currency swaps on a more multilateral basis (SaKong 2010), as discussed below. There is a win-win “grand bargain” to be struck between advanced and emerging economies (Goldstein 2009). Under such a bargain, the advanced economies would agree to push for more generous “insurance” facilities and for a further shift in “chairs and shares” to the emerging world (discussed below)—in exchange for a pledge by the latter to adhere to strengthened international “rules of the game” on exchange rate policy. However, the aggregate size of the safety nets currently under consideration is much smaller than existing holdings of foreign exchange reserves, so it is not clear that these proposals will have a major effect on reserve accumulation.

A fifth challenge concerns advisable structural reforms to raise individual countries’ potential growth rates. The challenge for the G20 is twofold: first, by their very nature, structural reforms are country specific; hence considerable knowledge of each individual country is required. Second, almost by definition, structural reforms are politically difficult—if easy mechanisms to accelerate growth rates were available, they almost certainly would already have been adopted. Under such circumstances, the G20 may play a constructive role in acting as a kind of neutral sounding board, providing a source of multilateral external encouragement for governments to undertake politically difficult actions and providing analytical support to demonstrate the benefits of such reforms. In the first stage of the mutual assessment process, G20 governments

² Some commentators have objected that the relaxation of conditionality and introduction of insurance mechanisms could increase moral hazard both among policy makers and market participants. While the expression of such concern sometimes appears exaggerated, moral hazard concerns cannot and should not be ignored. In designing appropriate criteria for qualification, relevant attachment of conditionality and caps on available liquidity are good examples of design features to minimize moral hazard in financial safety nets. With careful design, the moral hazard risks associated with global financial safety nets need not be any greater than those already inherent in the IMF’s current lending facilities with ex-post conditionality.

agreed to labor, product, and service market reforms, as well as actions to reduce barriers to competition-enhancing cross-border activities at the country group level. The challenge in the current stage of the process is to bring this down to the individual country level beyond the Seoul Summit.

Finally, while the G20 is a broadly representative assemblage, it is not universal. Specifically some developing countries in Asia and many largely poor countries more generally are not members. As part of its development agenda, discussed below, the G20 can work with developing countries to maximize their contribution to global recovery and growth.

Finance Sector Reform

There is a consensus among many observers that failures of finance sector regulation were at the heart of the global financial crisis. Starting at the Washington Summit in November 2008, G20 leaders initiated a finance sector reform agenda consisting of four pillars: a strong regulatory framework; effective supervision; the related issues of “too big to fail” systemically important financial institutions and cross-border resolution; and transparent international assessment and peer review.

Strong Regulatory Framework

Asset Bubbles

Any credible story about the origins of the global financial crisis has to give a role to easy credit conditions, a rapid run-up in housing and equity prices, and broad mispricing of risk. The precrisis orthodoxy was that it was unwise and unnecessary to ask central banks to prick asset-price bubbles for at least three reasons. First, it was said that central banks have no reliable methodology for, or comparative advantage in, identifying such bubbles. Second, even if they could identify such bubbles, short-term interest rates were not a good instrument for pricking them. And third, preemptive action was unnecessary: any post-bubble mess could be cleaned up at low cost by engineering a swift and sizable decline in policy interest rates.

The crisis has upended that (precrisis) orthodoxy. The “we can clean it up cheaply after the bubble bursts with low interest rates” argument can be discarded—at least for cases where the buildup of the bubble involves significant leverage. More fundamentally, the crisis has underlined the need for a better bubble-busting toolkit. A gathering consensus among policy makers, regulators, and economic pundits is that this toolkit should certainly include a countercyclical capital buffer and forward-looking provisioning for banks. It should also include countercyclical changes in loan-to-value ratios on residential and commercial mortgages, in lending standards, and in collateral and margin requirements for equities. True, such macro-prudential actions run the risk of killing off some expansions too soon, but they also could avert severe collapses like the recent one.

Capital and Liquidity

The global crisis has highlighted the inadequacy of the previous international regime for bank capital (and liquidity) requirements. A weak bank capital and liquidity regime, both in terms of quantity and quality, was one of the major contributing factors to the crisis. Under the precrisis international standard, the definition of Tier 1 bank capital was excessively broad and allowed for substantial country differences. For example, mortgage servicing rights in the US, tax-deferred assets in Japan, and minority interest in subsidiaries in Europe all qualified as bank capital in these regions. This broad definition of bank capital allowed banks to rely on cheaper, lower-quality capital.

In actuality, banks in the US and the eurozone failed the ultimate stress test: following a long secular decline in capital and liquidity ratios, many major banks were able to survive this crisis only with massive government support. But even with that support, loan growth went negative. Regulators now acknowledge that some of the principal innovations of Basel II—particularly the increased emphasis on credit ratings and on banks' internal models for risk weights—were deeply flawed and that the (precrisis) decisions not to increase the level and quality of capital or to be tougher on capital requirements for the risk in banks' trading books were mistaken.

At the Pittsburgh Summit, G20 leaders committed to developing by end-2010 internationally agreed rules to improve both the quantity and quality of bank capital and to discourage excessive leverage. These rules will be phased in as financial conditions improve and as economic recovery is assured, with the aim of implementation by end-2012. In September 2010, the Basel Committee on Banking Supervision announced a new definition of bank capital and framework for determining adequate capital and liquidity.

However, when it comes to financial regulation and reform, there is a natural tendency for countries whose financial institutions were not major players in the recent financial meltdown to step aside, criticize those institutions and jurisdictions that were principally involved, and decline to participate in a strengthened regulatory and supervisory regime. That would be a mistake. Yesterday's cautious institutions can quickly become tomorrow's high fliers. Meanwhile, institutions in the major jurisdictions will use the very real threat of regulatory and institutional arbitrage to water down agreed reforms. There are reasons to believe that these innovations, while welcome, are inadequate, and bank capital and liquidity requirements will continue to be a recurring feature of G20 deliberations (Goldstein 2010).

The Basel III agreement would, among other things, allow banks to meet up to 15% of the common equity component of the Tier 1 capital requirement with deferred tax assets, mortgage-servicing rights, and significant investments in the common shares of unconsolidated financial institutions; effectively drop the proposed medium-run liquidity standard (the net stable funding ratio) until at the earliest January 2018, while softening considerably the definition of liquid assets in the short-run liquidity standard; and test a minimum Tier 1 leverage ratio of only 3%, with implementation scheduled only for January 2018. In short, while the crucial parameters for



the minimum capital ratios—as well as for capital conservation and countercyclical buffers—are yet to be decided, Basel III is in danger of emerging as a “mouse” rather than as the cornerstone of a transformed system.

In an outline of what would qualify as a serious reform of bank capital requirements, two observations are instructive. The first comes from studies of bank capital requirements (Hanson, Kashyap, and Stein 2010a, 2010b). Markets were recently (first quarter 2010) pressuring the four largest US banks—at the lower end of the cycle—to hold a common Tier 1 capital ratio of about 8% (of risk-weighted assets). Since US banks lost about 7% of risk-weighted assets during 2007–2010 in the wake of the financial crisis, Hanson, Kashyap, and Stein (2010a) conclude that the minimum capital requirement at the top of the cycle ought to be around 15%. So long as banks are given a reasonable transition period to meet these higher capital requirements, there is also little likelihood that even very large increases in capital requirements would lead to large increases in loan prices and large declines in loan volumes.

The second observation comes from Switzerland’s recent unilateral reform of bank capital requirements. The Swiss regulatory authorities mandated in December 2008 that UBS and Credit Suisse would have to meet much tougher capital and liquidity standards by January 2013. In good times, the minimum revised Tier 1 capital ratio (to risk-weighted assets) would have to be 16%—more than 6 percentage points higher than the previous target; in addition, a minimum (unweighted) leverage ratio of 5% was introduced. Not only did the two large Swiss banks satisfy the tougher capital standard way ahead of schedule, but the macroeconomic impact on lending has been anything but calamitous.

Financial Market Infrastructure: Hedge Funds, Credit Rating Agencies, Over-the-Counter Derivatives, Accounting Standards, and Compensation Practices

There is broad consensus among G20 governments that absence and/or inadequacy of rules and regulations about hedge funds, credit rating agencies, and nontransparent trading in nonstandardized over-the-counter derivatives contributed to the financial crisis. Broadening regulatory scope and increasing regulatory consistency is important at the global, regional, and national levels.

In February 2010, the International Organization of Securities Commissions published an agreed template for the global collection of hedge fund data and its dissemination among regulators to facilitate international supervisory cooperation. Legislation to establish registration, reporting, and oversight arrangements for hedge funds and advisors is advancing in major jurisdictions, notably the European Union (EU) and the US. Given the increasing prominence of sovereign wealth funds, the further development of international regulatory mechanisms could be welcome in this sphere as well (Truman 2010a).

It is widely believed that credit rating agencies contributed to the crisis by underestimating risks associated with structured credit products and lagging the market in revising their ratings. In Toronto, G20 leaders committed to a number of reforms, and called on the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision to report the progress to G20 finance ministers and central bank governors in October 2010. The FSB report (FSB 2010) sets out a number of principles to reduce the mechanistic reliance by market participants on credit rating agencies and establishes a work program for standard setters and regulators to incentivize market participants to improve their independent credit risk assessment and due diligence capability, and to reduce their reliance on these agencies.

In the area of over-the-counter derivatives, G20 leaders committed in Pittsburgh to increased transparency in the trading of these contracts by end-2012, and work is under way through a variety of channels including the International Organization of Securities Commissions and the FSB to realize these commitments.

In Toronto, G20 leaders once again reiterated the necessity of establishing universal high-quality accounting standards. Currently the focus of discussion is on the scope of fair value—mark-to-market versus wider fair value, based on long-term historical value. A broad range of issues also exist as to how to harmonize different accounting and regulatory treatments in relation to capital, off-balance sheet assets, and provisioning. The leaders urged the International Accounting Standards Board and Financial Accounting Standards Board to redouble their efforts to complete their convergence project by end-2011. Work in this area continues. Compensation practices have been a central concern with the propagation of principles, implementation guidance, and FSB monitoring of compliance.

The Basel Committee on Banking Supervision and the FSB were to assess progress in implementing these goals and report to the G20 finance ministers and central bank governors in October 2010 if additional work is warranted. As observed by Stephane Rottier and Nicolas Véron (2010), the implementation of global reporting standards is not feasible in the short run, and as a consequence, it may be advisable to adopt a principle of subsidiarity, in which standards would be implemented at the national level. However, where suitable bodies do not exist, policy makers should be ready to create them as may be required for the oversight of credit rating agencies, global audit networks, or securities clearinghouses. Intensive peer review has been one of the approaches emphasized by the FSB, and a report on Mexico was completed in September 2010. Reports on Australia, Canada, and Switzerland are due in 2011.

Effective Supervision

At the June 2010 Toronto Summit, G20 leaders identified more effective oversight and supervision as an essential component of finance sector reform. In this regard, the FSB, in consultation with

the IMF, reported to the finance ministers and central bank governors meeting in October 2010 with recommendations. The FSB process should be strengthened by expanding it into a proper international self-regulatory institution and by providing the IMF with the specific mandate under its articles of agreement to address financial stability.

Systemically Important Financial Institutions and Resolution

Too Big or Too Interconnected to Fail

The crisis established that bank and nonbank financial institutions, either individually or collectively, can pose risks to financial stability or trigger contagion when they are closely connected to regulated entities or have a concentration of assets giving rise to systemic risks. According to Andrew Haldane (2010), 145 global banks with assets over \$100 billion each accounted for more than 90% of the government support during this crisis. Also, top-3 and top-5 concentration ratios (for bank assets relative to GDP) have increased sharply in large advanced economies over the past two decades, despite scant evidence of either economies of scale or economies of scope in banking beyond \$100 billion in assets (**Figure 6**). Large

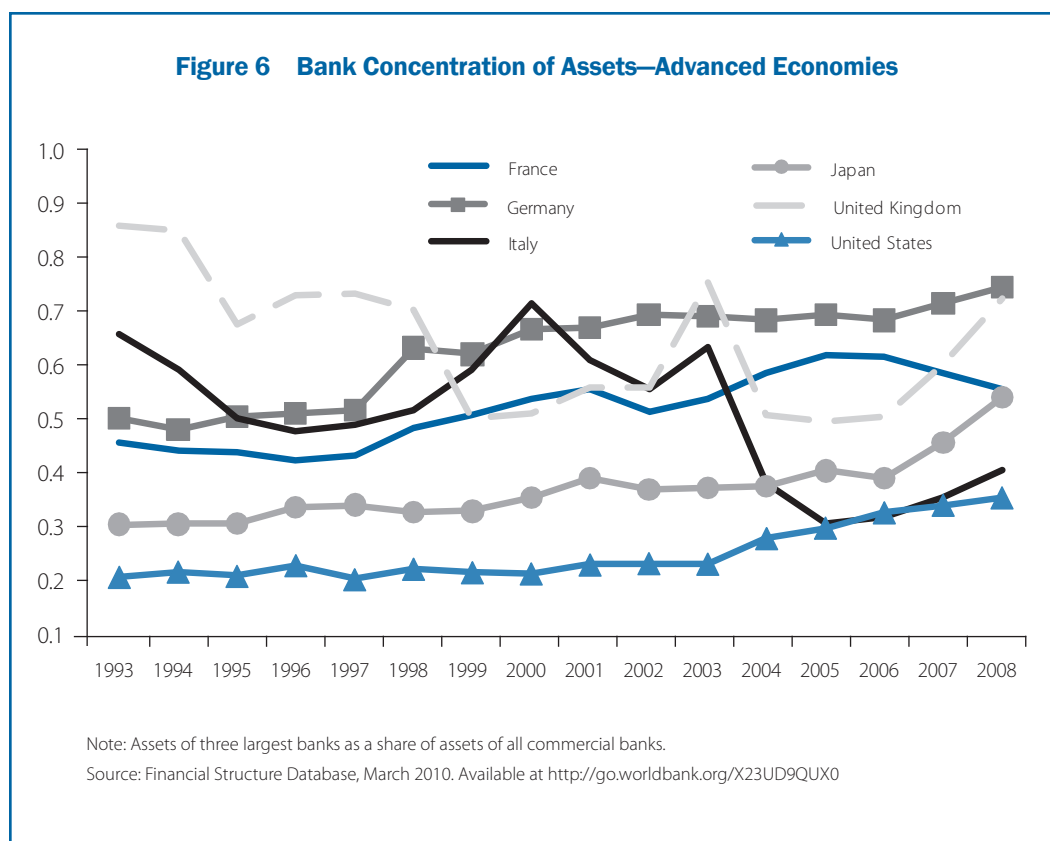
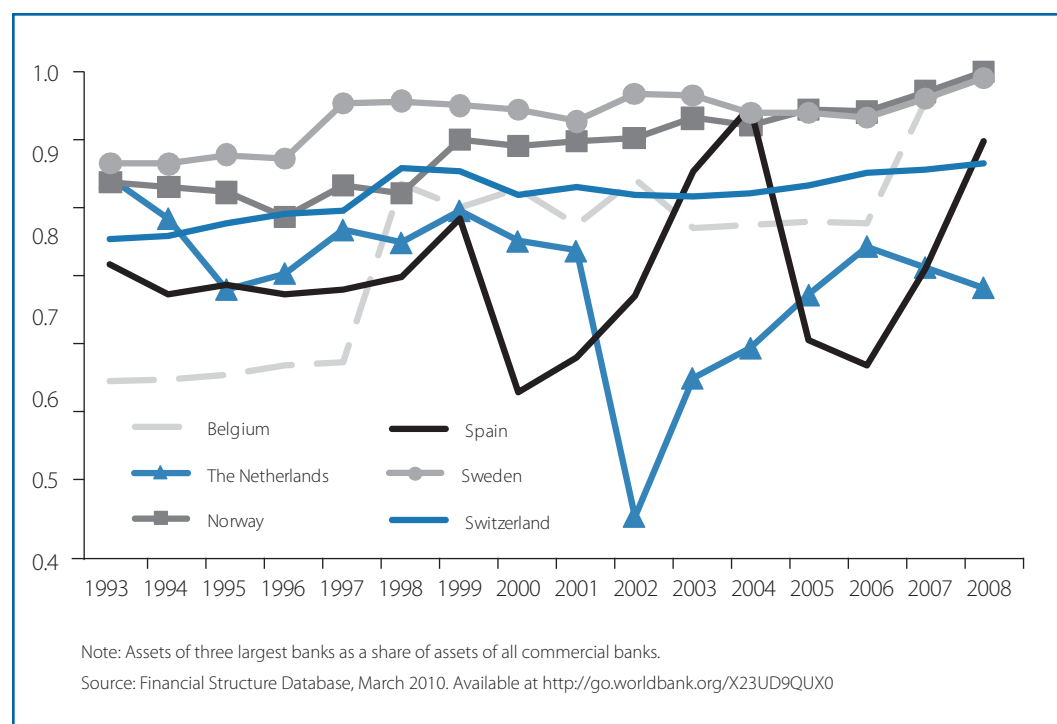


Figure 6 *continued*

and complex financial conglomerates now have hundreds—and sometimes thousands—of majority-owned subsidiaries (Carmassi and Herring 2010). The G20 committed in Toronto to establishing a system where authorities have the capacity to restructure or resolve all types of financial institutions in crisis, without taxpayers ultimately bearing the burden. These powers should facilitate “going concern” capital and liquidity restructuring as well as “gone concern” restructuring and wind-down measures.

Addressing these issues will require an expanded toolkit, encompassing the following measures: (i) higher capital and liquidity requirements for the largest, most interconnected, and most complex financial institutions (to internalize the externalities associated with the higher expected cost of resolving such institutions); (ii) mandatory wind-down plans for such systemically important financial institutions, approved by the regulatory body charged with primary supervisory responsibility; in cases where the wind-down plan is inadequate, the supervisor would have the authority to require the institution to shrink and become less complex; (iii) ensuring that special resolution authority exists for all systemically important financial institutions—whether banks or nonbanks—so that there is a viable alternative to over-the-weekend massive bailout of the failing firm (Cohen and Goldstein 2009); (iv) designing resolution authority in a way that supports market discipline; this means wiping out shareholders, changing management, and paying off creditors promptly at expected recovery cost (not at par), and it also means funding

resolution in large part with fees on the larger financial firms; (v) imposing binding explicit size caps (relative to GDP) on the size of systemically important financial institutions, so as to limit the size of losses in case of failure; even if such size caps were different across countries and were imposed on a national (not international) basis, they would go a long way to retarding the growth of “too big to fail” entities; and (vi) requiring that a share of bank debt be convertible to common equity under prespecified stress conditions. In the absence of a global regulatory authority, in some instances these policies imply changes to national resolution and insolvency processes and laws to provide the relevant national authorities with the capacity to cooperate and coordinate resolution actions across borders.

These measures should be undertaken jointly because none of the individual policy prescriptions by itself is likely to be effective enough (or perhaps salable enough) to solve the problem. When put together, however, these measures offer a workable plan for confronting “too big to fail” if—and it is a big “if”—regulatory authorities are willing to activate such measures.

An interim report on this issue was submitted by the FSB in Toronto; final recommendations were submitted to the Seoul Summit. As in the case of bank capital and liquidity standards, it remains to be seen if the recommended measures will be adequate to resolve the problem.

Finance Sector Responsibility

At the Toronto Summit, the G20 agreed that the finance sector should make a fair and substantial contribution toward paying for any burdens associated with government interventions, where they occur, to repair the financial system, fund resolution, or mitigate the risks of the financial system. To that end, it recognized that there is a range of policy approaches, embodying a set of common principles including protecting taxpayers, reducing risks from the financial system, protecting the flow of credit in good times and bad, taking into account individual countries’ circumstances and options, and helping promote a level playing field. Some countries are pursuing the idea of a bank or financial levy, a policy that has been considered extensively at the IMF.

Transparent International Assessment and Peer Review

The G20 pledged to support independent international assessment and peer financial system review through the IMF and World Bank’s Financial Sector Assessment Program (FSAP) and the FSB peer review process. The IMF has adopted a mandatory requirement that 25 member countries with systemically important financial sectors receive FSAPs at least once every 5 years. The FSB intends to formalize and intensify outreach to governments beyond the membership of the G20. The G20 in Seoul also unveiled an anticorruption action plan.

Reform of International Financial Institutions

The Seoul Summit presented G20 leaders with an opportunity to demonstrate their concrete support for the informal and formal international financial institutions (IFIs) of the global system. The G20's overarching objective should be to strengthen existing institutions, not to supplant them. To date, the G20 has a good record in building on the expertise of international organizations such as the IMF, World Bank, the Organisation for Economic Co-operation and Development (OECD), and FSB, while stimulating and advancing a work program of global action and reform.

The risk is that countries individually and collectively in their regional and subregional groups will fail to learn the central lesson of the crisis: all countries were adversely affected and a coordinated global response was required (and produced) to maximize the positive effects and minimize free riding and negative spillovers. Therefore, global institutions, in particular, need to be strengthened and supported. It also follows from the scope of the recent crisis that global institutions like the IMF and those in the World Bank Group may have priority over regional and subregional institutions, precisely because they are global in their orientation and activities.

On IMF reform, G20 leaders in Seoul reached consensus on a number of key issues. Most important was the size of the overall increase in IMF quotas. The leaders in Seoul endorsed a doubling of quotas, but without adding to the total financial resources available for IMF lending because the size of the New Arrangements to Borrow will be reduced by about roughly the same amount. Also important was reducing the representation of Europe on the IMF executive board from the current eight to ten chairs toward an ultimate target of two, or at most three, chairs. An initial step was agreed in this direction with a commitment to reduce European chairs by two seats.

The Pittsburgh commitment "to a shift in quota share to dynamic emerging market and developing countries of at least 5 percentage points from over-represented to under-represented countries" should have been interpreted as requiring a shift of quota share away from the traditional advanced economies to the emerging market and developing countries, in particular those that are most dynamic, and a simultaneous broader redistribution from overrepresented to underrepresented countries within both groups (**Table 1**). In the event, a shift of 6 percentage points was agreed, but less than half that amount will go to dynamic and emerging market economies as a whole.

**Table 1 Summary of International Monetary Fund Voting and Quota Share Shifts**

	From Pre-2008 Reform	From Post Second Round ^a
Shift of voting shares (ppts)		
to underrepresented countries	8.2	5.8
to dynamic EMDC	8.8	5.7
to EMDC	5.3	2.6
to non-oil EMDC ^b	7.7	3.9
Shift of quota shares (ppts)		
to underrepresented countries	8.5	6.2
to dynamic EMDCs	9.0	6.0
to EMDCs	3.9	2.8
to non-oil EMDCs ^b	6.4	4.2
Number of countries that increase quota share	54	61
Advanced countries	10	8
EMDCs	44	53
Number of countries that increase or maintain quota share	54	110
Advanced countries	10	8
EMDCs	44	102
Number of countries with nominal quota increases greater than 150%	40	16
Advanced countries	6	3
EMDCs	34	13
Adjustment coefficient^c	65.8	55.7

ppts = percentage points; EMDCs = emerging market and developing countries.

^a Post second round includes ad hoc increases for 54 eligible members that are not yet effective; also includes Kosovo and Tuvalu which became members on June 29, 2009 and June 24, 2010, respectively. For the two countries that have not yet consented to, and paid for, their quota increases, 11th Review proposed quotas are used.

^b Oil-exporting EMDCs are those that The World Economic Outlook classifies in the functional group "fuel exporters," consisting of 27 countries.

^c The adjustment coefficient measures the extent to which deviations between actual and calculated quota shares are reduced by the quota adjustment. The pre-Singapore calculations exclude Kosovo and Tuvalu.

Source: International Monetary Fund. Available at www.imf.org/external/np/sec/pr/2010/pr10418.htm

Another crucial issue was the presumptive use and status of the IMF quota formula that was agreed on in early 2008. The best way to deal with this issue would have been to employ what in effect would be a revised new formula that could be blended with the 2008 formula to produce the agreed result. That approach could be accompanied by a commitment to phase out the flawed 2008 quota formula over time in favor of the revised new formula. The Seoul agreement did not involve the introduction of a revised formula to construct the basis on which to redistribute quota shares, but the agreement did commit countries to a revision of the formula by January 2013 in preparation for the next quota review, which was advanced 2 years to January 2014.

Of marginal importance was a possible symbolic decision in Seoul to abandon the convention that the head of the IMF should be a European citizen and the head of the World Bank should be a US citizen. Much more important to all the IFIs would have been a commitment to open, merit-

based processes irrespective of nationality for the choice of all their senior officials down to the level of department heads in the IMF and the equivalent in the World Bank and the other IFIs. In Seoul, no such decisions were made.

The lesson of the global crisis is that the IFIs, the IMF in particular, are essential to effective crisis management and to limiting, or preventing, crises. The world is not ready for a global central bank that can act as an international lender of last resort to the international financial system as a whole, but the recent crisis has demonstrated that the IMF should be moved closer to this role.

The leaders and citizens of some key countries do not agree with this proposition; they articulate concerns about wasting taxpayers' money and combine those arguments with simplistic moral hazard concerns associated with IFI lending. All IFI lending activities involve a balance between the provisions of financial assistance on concessional terms and the promotion of policy reforms through programs or surveillance. Actual and potential financial assistance may contribute to moral hazard. The issue is whether the associated reforms are worth the risks. It is important to get this balance right, which has not recently been the case. For example, in January 2008, the IMF governors acquiesced in the judgment that the IMF did not need a general increase in quota resources. As the crisis was unfolding, the balance was tipped too far toward starving the IMF, and the other IFIs, of financial resources. As a consequence, the IFIs under G20 leadership had to scramble during the crisis to assemble financial resources.

It is naïve to believe that there will not be other crises in the future. That is why it was essential that the authorities in the Republic of Korea made significant progress in their quest to strengthen the global financial safety net provided by the IMF and move it closer to being an international lender of last resort. A crucial element of this package is to provide the IMF with sufficient financial resources to play this role, which is why doubling the size of the IMF quotas and hence adding to the IMF's overall resources in the process would have been important as part of the Seoul package. However, the Seoul agreement, while doubling the IMF quotas, does not increase the total available IMF resources. The plan to simultaneously reduce the size of the New Arrangements to Borrow by the same amount will essentially leave the IMF's lending capacity unchanged. Other mechanisms to mobilize IMF financing are also appropriate: special drawing right (SDR) allocations and temporary swap arrangements with the central banks that issue international currencies.

An associated component to this reform of IMF lending should be to integrate better the IMF's surveillance and financing roles. One possibility would be a framework for such integration based on the IMF's Article IV consultation process: comprehensive prequalification (Truman 2010b). For every member of the IMF, its Article IV review should include a staff judgment on the nature of the policy conditions, if any, necessary to qualify that member for IMF financial assistance if needed. This proposal remains on the agenda for the future.

Relationship between Global and Regional Financial Institutions

With the increase in the frequency and severity of financial crises, the expansion in the number and size of regional financing arrangements, and the dramatic increase over the last decade in the level of international reserves that can be placed at the disposal of bilateral and regional facilities, the necessity and complexity of coordinating these facilities with global institutions such as the IMF increases dramatically. The plethora of regional financing arrangements raises the stakes on policy issues (such as the relative contributions of regional and multilateral facilities, conditionality, terms, and negotiating modalities) and institutional issues (such as channels of communication, representation, and even membership). Given its momentum, regionalism poses the most important long-term challenge to the IMF and its role in the international monetary and financial system.

Three events make this agenda particularly important at the moment. First, ASEAN+3 has made the Chiang Mai Initiative Multilateralization (CMIM) operational and is creating a surveillance unit based in Singapore in early 2011. Second, the financial crisis in Europe's southern tier led to a rescue package for Greece of unprecedented size and the establishment of a nearly \$1 trillion arrangement that, if activated, would mix European and IMF financing. The stakes in mixed packages have increased dramatically and are now enormous. Finally, the IMF has updated its lending facilities and is reviewing proposals to address systemic shocks and improve collaboration with regional facilities, as tasked by the Seoul Summit.

Cooperation between the IMF and European authorities in recent programs in Central and Eastern Europe and in Greece, while successful, is not likely to be easily replicated in other regions. The European numerical dominance at the IMF and the European identity of the managing director—a person intimately familiar with the decision-making machinery of the EU, eurozone, and key member states—renders the intimacy of this cooperation specific to Europe. Choosing an Asian managing director, while desirable on other grounds, will not solve this problem but would, rather, improve cooperation with one region at the expense of cooperation with another. The IMF and regional financing arrangements should therefore arrange key elements of cooperation in advance, rather than negotiate them in the midst of crises as they have done in the past.

G20 members hold 80% of the quotas and 79% of the votes of the IMF. At the same time, almost all of them participate in a bilateral or regional financial arrangement; one member, the EU, is itself a regional organization that operates a financial arrangement. As essential players at all these levels, the members of the G20 are best situated to mandate cooperation among them. The G20 is therefore the logical group to guide the agenda for cooperation between regional institutions and the IMF. As proposed by Henning (2010), that “Interinstitutional Agenda” should have three components: measures that would apply under new facilities at the IMF, a code of conduct based on a set of agreed principles, and deeper institutional reforms.

Measures under New Facilities at the IMF

Having updated the institution’s facilities, members of the IMF continue to review proposals for combating systemic shocks. Included in this agenda are several proposals for how the IMF could cooperate with regional financing arrangements, and vice versa, now that new facilities are in place. Specifically, the CMIM could make qualification under the updated flexible credit line (FCL) and the new precautionary credit line (PCL) sufficient to satisfy the IMF link and thus qualify for CMIM disbursements. ASEAN+3 could disburse in parallel with IMF disbursements under a multicountry activation of the FCL for the emerging-market economies of Southeast Asia, for example, or, should it eventually be introduced, a Global Stabilization Mechanism. The G20 finance ministers and heads of government should advance proposals for their regional financing arrangements generally to cooperate with the IMF in these ways.

But, in laying the groundwork for successful interinstitutional cooperation, the G20 should go much further by endorsing a set of principles for both the IMF and regional financing arrangements and by urging their adoption by those institutions—the second component of the framework.

A Code of Conduct Based on a Set of Agreed-On Principles

Transparency. Transparency varies significantly across regional arrangements and the IMF. Once relatively opaque, the IMF has become remarkably more transparent during the 13 years since the Asian financial crisis of 1997–98. The Federal Reserve swap agreements are now posted at the time of the announcement of the agreement and drawings are reported weekly in Federal Reserve statistical releases. The CMIM, on the other hand, has lagged: ASEAN+3 finance ministers have published a summary of the agreement establishing the CMIM but not the agreement itself. Differences across facilities will tempt some parties to use the least transparent facility in a financial rescue. To enhance public understanding, market credibility, and interinstitutional cooperation, regional financial facilities should establish an internationally compatible and transparent mechanism for their operations.



Multilateral Review. It would be useful to have a mechanism for formal review of regional facilities through either the IMF or other multilateral arrangements. The international community has reviewed the consistency of regional financial facilities with countries' multilateral commitments in a completely ad hoc fashion or has failed to review them at all. There is no procedure through which such arrangements are evaluated formally. Some have been discussed by the IMF's executive board but have not been the focus of sustained board review. Such reviews may be needed to identify any potential conflicts among these arrangements and the IMF, and to anticipate any sticking points in negotiations over parallel financing. It is far better to identify such snags in advance than to encounter them unexpectedly during 11th-hour bargaining in a financial crisis.

Conditionality. Policy conditionality is a critical question in the relationship between the IMF and regional financing arrangements. When grappling with crises, the IMF and regional facilities must not compete by relaxing the policy adjustments required of borrowers. Despite its acknowledged mistakes, the IMF holds a comparative advantage over regional and multilateral organizations in the specification of conditionality by virtue of its analytical resources, experience, and global perspective that confers a unique ability to draw lessons across countries and regions. Regional financing arrangements are thus wise to import or borrow the IMF's conditionality.

However, the comparative advantage of the IMF in this respect should not be considered absolute. The Latvian program of 2008 represents a case where the region prevailed over the IMF on an important element of policy adjustment. EU officials argued against currency devaluation, which most leading members of the IMF staff and some members of the executive board favored. The managing director and responsible European Commissioner came to an agreement whereby the European position was accepted and the EU contributed a greater share of a larger overall package, a program which has so far been quite successful. In principle, if a regional arrangement develops analytically sound, high-quality conditionality, it ought to be able to substitute that for IMF conditionality. The critical considerations are the quality of the program, not the institutional origin, and the operational coordination of the work of the region with that of the IMF.

The stigma associated with the past IMF conditionality also remains very real in many emerging and developing economies. In Asia especially, the stigma concern goes beyond the simple economic sense of being seen financially weak to international investors, but rather it is a complex political risk for the national authorities to lose face to their own constituencies. In many parts of Asia, the Asian financial crisis is still dubbed as "the IMF crisis." For proud Asians who achieved the "Asian miracle," the shame of having to render their economic sovereignty to the IMF, which seemed to represent the interest of Western capitalists, has had long-lasting impact. And on the back of regained economic strength, a new nationalism rises. The IMF has introduced new lending facilities that rely more on ex-ante qualifications rather than

ex-post conditionality for lending to reduce the stigma (discussed in the next section). Yet little enthusiasm by potential borrowers seems to arise. Again, the prevailing stigma is in large part due to the concern of emerging market economies or regions about their underrepresentation and limited influence in the IMF's decision making. Unless this fundamental problem is properly addressed, no piecemeal reform on the mode of facilities would be able to allow effective use of IMF resources during a crisis.

Bailing In the Private Sector. Recognizing a predominant concern in the resolution of recent crises, regional groups must avoid guidance to the private sector and policies that could undercut the IMF's (and their own) efforts to stabilize countries. For example, regional arrangements must not encourage banks to reduce their exposures to countries that have borrowed from the IMF. Nor should the IMF undercut arrangements that might be agreed within the regions in the future regarding private sector involvement and sovereign debt restructuring.

Cooperation. The IMF is unique among crisis-fighting facilities in the universality and diversity of its membership. It remains the final resort in efforts to combat regionwide and systemic financial crises. Whereas a regional financial facility can turn to the IMF if a regional operation fails, there is no fallback among international financial facilities if an IMF operation fails. All the IMF members thus have a strong interest in maintaining confidence in the institution. For these reasons, the IMF should retain the status of preferred creditor, at least for the time being.

However, inadequate reform in the IMF governance structure undermines its role as the global financial safety net provider. Despite the efforts to address the stigma concern, delayed reform of IMF governance led to a proliferation of regional arrangements. Asia already moved forward in establishing national and cross-border crisis management and resolution mechanisms, notably ASEAN+3's CMIM. This \$120 billion reserve pooling arrangement is to provide liquidity to any ASEAN+3 member in an emergency. There is a clear case of mutual benefits from explicit cooperative arrangements between such regional arrangements and the IMF in the global network of financial safety nets. Most regional arrangements still lack research capacity, human resources, experience, and the institutional setup to effectively support their operations, making cooperation with the IMF essential. Close cooperation with the regional arrangements offers a chance of mitigating the stigma concern in IMF operations. It will also help to change the perception of the geographic and political bias in the IMF, hence improving the credibility, legitimacy, and effectiveness of its policies.

Ideally, these principles would be incorporated into a code of conduct governing the relationship between regional facilities and the IMF. If, however, agreement on these points is unattainable—owing to heterogeneous preferences among the regions—the G20 should advance cooperation along each of these points separately.



Deeper Institutional Reforms

With respect to the third, deeper institutional reforms, regional financing arrangements should create clear and coherent mechanisms for external representation, in order to engage the IMF and other international financial institutions. External representation of the eurozone was an afterthought in the Maastricht Treaty and, while now established, is cumbersome and often contentious. No explicit arrangement for representation has been agreed among ASEAN+3; the IMF must engage with CMIM through its members, none of which is authorized by the group to speak for the region.

For its part, the IMF and other IFIs should provide mechanisms for facilitating and receiving the collective representation of the regional institutions. The eurozone is represented in the executive board under arrangements involving the EU presidency, European Commission, and European Central Bank. Though workable, the arrangement is complex and not at all clearly replicable in other regions.

Finally, the agenda raises the question of membership of regional organizations in the IMF. At present, only national governments are members of the IMF. Monetary unions that meet a high standard of cohesiveness and have adopted majority decision making should be accepted as members of the IMF, their member states having surrendered monetary sovereignty to the regional union. Such a move would certainly facilitate coordination with the eurozone. Considerable streamlining is likely to be necessary if the IMF is to work simultaneously with a number of regions effectively.



Global Financial Safety Nets

The global financial crisis highlighted the speed at which events in one market can rebound in another. Countries with seemingly little financial difficulty quickly found themselves affected by sudden reversals of capital flows and serious volatility in their financial markets, including their foreign exchange markets.

One can envision a concentric series of defenses against this kind of externally generated financial shock beginning with national policies and eventually reaching global mechanisms. The first line of defense could be *prudential regulations and sound macro-policies* implemented at the national level. The recent crisis experience suggests that these should be considered necessary, but not sufficient, to avoid financial crisis. Another response at the national level is *reserve accumulation as self-insurance* by some emerging economies. In the aftermath of the Asian financial crisis, some countries—especially in East Asia—have accumulated large reserves as a form of self-insurance. Foreign reserve accumulation also causes direct and indirect costs, at both domestic and global levels. At the country level these include the opportunity cost of keeping a large part of national wealth in holding developed countries' financial instruments rather than investing it in domestic projects with higher returns and the impact on domestic monetary conditions (if sterilization reaches very high levels). The crisis demonstrated that even this policy is not foolproof, as countries such as Republic of Korea experienced significant financial market turbulence despite possessing large reserves. Additionally, it is very difficult to calculate “the optimal level of reserves,” and as a consequence, self-insurance and mercantilism are observationally equivalent. A crisis-prevention policy based on the massive accumulation of reserves is impossible for the global economy as a whole and risks a protectionist backlash in current account deficit countries.

The second line of defense could be *bilateral swap lines* with key currency-issuing countries. The Republic of Korea regained market confidence once it announced a \$30 billion bilateral swap arrangement with the Federal Reserve, though it is unclear why a \$30 billion swap line would be so important insofar as the Republic of Korea had roughly \$200 billion of reserves remaining. There are a variety of possible explanations that bear on the assessment of the efficacy of bilateral swaps. The most positive interpretation is that the bilateral swap arrangement represented a significant signal of confidence and calmed the market. A less complimentary explanation is that it was widely believed in the market that the authorities in the Republic of Korea were committed to maintaining \$200 billion in reserves, so as the reserve level dwindled



to near this threshold, \$30 billion was a large contribution to “effective” reserves at the margin. In this interpretation, the swap was effective—but only because of the decision of the relevant authorities to effectively take \$200 billion of reserves off the table. A third interpretation is that the nature of the crisis, involving the financial sector in the US, made it economically and politically difficult for the authorities in the Republic of Korea to massively disinvest reserves that were largely held in US dollars in US financial institutions that were under strain. Under such circumstances, where selling of dollar-denominated assets in the Republic of Korea might be interpreted as worsening the US financial crisis and so adding fuel to the fire, the provision of dollars via a bilateral swap would address in balance-of-payments problem in the Republic of Korea but avoid the possible intensification of the financial crisis in the US.

Regional instruments represent a third response mechanism. For example, during the crisis, regional arrangements such as the EU medium-term financial assistance facility and European Bank Coordination Initiative played an important role in addressing the crisis in Eastern Europe. But in most other regions, regional arrangements are not as well developed and have not been as important in crisis resolution. Even in Europe, where regional cooperation is the most advanced, the recently established European Stability Mechanism is regarded as a supplement—not a substitute—for the global response represented by the IMF. Considering the relative ease with which finance sector shocks propagate interregionally, if not globally, regional responses by themselves have inherent limitations. Some, however, voice the need for the development and advancement of regional institutions such as the now multilateralized Chiang Mai Initiative to complement and augment the role of the IMF, which has a diverse membership and so, too, many diverse interests (ADBI 2010).

Crisis experiences since the 1990s have encouraged the IMF to rethink its *global* crisis prevention programs. There are two related issues. First, there is a need for rapid disbursement without significant conditionality, encouraging a trend toward “preapproval-type” approaches based on the comprehensive assessment for prequalification. Second, the IMF is deeply unpopular with many publics around the world, and as a consequence, governments may be reluctant to approach the IMF, even when objective economic conditions warrant it. (There is also the possibility that involvement in IMF programs may act as a negative signal to markets.) These considerations lie at the heart of the reluctance—even stigma—at becoming involved with the IMF.

The flexible credit line (FCL) introduced in the midst of the recent crisis, involves no ex-post conditionalities (**Table 2**). Yet only three (relatively secure) countries accessed the FCL, and they applied after the worst of the crisis had passed, suggesting that the stigma in either its political or economic manifestation may be at work. In addition to the FCL, the IMF introduced a precautionary credit line (PCL) in August 2010. It is also considering a global stabilization mechanism, as well as ways to strengthen coordination with regional financing arrangements. Apart from the specific form of the safety net, as previously observed, resources are an issue. More importantly, however, the required reform of IMF governance should be advanced to enhance the role of IMF financing for global financial safety nets.

Table 2 International Monetary Fund New Facilities

Concessional Facilities for Low-Income Countries (LICs)			
	Extended Credit Facility (ECF)	Standby Credit Facility (SCF)	Rapid Credit Facility (RCF)
Purpose	To support countries' economic programs aimed at moving toward a stable and sustainable macroeconomic position consistent with strong and durable poverty reduction and growth	To support LICs that have reached broadly sustainable macroeconomic positions, but may experience episodic, short-term financing and adjustment needs, including those caused by shocks	To provide low access, rapid, and concessional financial assistance with limited conditionality to LICs facing an urgent balance-of-payments need
Eligibility	Available to all Poverty Reduction and Growth Trust (PRGT)-eligible member countries that face a protracted balance-of-payments problem	Available to PRGT-eligible member countries facing an immediate or potential balance-of-payments need	Available to PRGT-eligible member countries that face an urgent balance-of-payments need
Duration and repeated use	Three-year period, extendable for up to 2 additional years	Ranges from 12 to 24 months; normally limited to 2.5 out of any 5 years	Outright disbursement either through one-off disbursements or repeated disbursements over a limited number of years
Conditionality	Member countries agree to implement a set of policies that will help them support significant progress toward a stable and sustainable macroeconomic position over the medium term	Member countries agree to implement a set of policies that will help them achieve a stable and sustainable macroeconomic position in the short term	Limited (outright disbursement without explicit program-based conditionality or reviews)
Lending terms	Financing under the ECF carries a zero interest rate, with a grace period of 5.5 years and a final maturity of 10 years	Financing under the SCF carries a 0.25% interest rate, but is subject to exceptional relief of all interest payments on outstanding concessional loans due to the IMF through end-2011. It has a grace period of 4 years, and a final maturity of 8 years	Financing under the RCF carries a zero interest rate, has a grace period of 5.5 years, and a final maturity of 10 years
Qualification criteria			

Source: International Monetary Fund. www.imf.org/external/np/exr/facts/howlend.htm

Nonconcessional Facilities		
	Flexible Credit Line (FCL)	Precautionary Credit Line (PCL)
Purpose	To reduce the perceived stigma of borrowing from the IMF and to encourage countries to ask for assistance before they face a full-blown crisis	To support countries with sound fundamentals and policy track records, but facing moderate vulnerabilities that may not yet meet the high FCL qualification standards. It combines a qualification process similar to FCL with focused ex-post conditionality aimed at addressing vulnerabilities identified during qualification
Eligibility	Available to member countries that meet the qualification criteria	Available only to countries that do not face an actual balance-of-payments need at the time of approval
Duration and repeated use	Works as a renewable credit line, which at the country's discretion could initially be for either 1 or 2 years with a review of eligibility after the first year	Works as a renewable credit line, with duration between 1 and 2 years. Countries that qualify under the PCL have large frontloaded access, with up to 500% of quota made available on approval of the arrangement and up to a total of 1,000% of quota after 12 months on satisfactory progress in reducing their vulnerabilities
Conditionality		Countries using the PCL should commit to a focused set of policies aimed at reducing the remaining vulnerabilities identified in the qualification process
Lending terms	The cost of borrowing under the FCL is the same as that under the traditional Stand-By Arrangements, which varies with the scale and duration of lending. The lending rate is tied to the IMF's market-related interest rate (basic rate of charge), which is linked to the special drawing rights (SDR) interest rate.	Subject to the same charges, surcharges, commitment fees, and repurchase period (3.5–5 years) as the FCL and Stand-By Arrangements
Qualification criteria	To qualify for an FCL arrangement, a member country should have: (i) sustainable external position; (ii) capital account position dominated by private flows; (iii) track record of access to international capital markets at favorable terms; (iv) comfortable reserve position; (v) sound public finances; (vi) low and stable inflation; (vii) no bank solvency problems; (viii) effective financial sector supervision; and (ix) data integrity and transparency	The criteria to assess whether a country qualifies for the PCL are the five broad areas encompassed in the FCL qualification criteria: (i) external position and market access; (ii) fiscal policy; (iii) monetary policy; (iv) financial sector soundness and supervision; and (v) data adequacy. Countries suffering any of the following problems at approval cannot access the PCL: (i) sustained inability to access international capital markets; (ii) the need to undertake large macroeconomic or structural policy adjustment; (iii) a public debt position that is not sustainable in the medium term with a high probability; or (iv) widespread bank insolvencies

Global financial systems appear to be inherently subject to periodic crises. There should therefore be an international financial architecture that is designed to address the nature of globalized finance and the associated risks of periodic crises. However, in a world of increasingly complex economic and financial activity, relying on a single institution for resolving national, regional, or global crises may be unrealistic. Global financial safety nets essentially require a global network of safety nets, encompassing the multiple layers of crisis-response systems at all these three levels.

A range of regional arrangements are being established and strengthened to combat potential crises (Arner and Park 2010). Asia has been at the forefront of such regional efforts and three important regional initiatives are noteworthy: liquidity provision—CMIM; macroeconomic and financial surveillance—ASEAN+3 Macroeconomic Research Office; and regional bond market development—Asian Bond Markets Initiative.

The international architecture should be designed to support such regional arrangements in preventing and managing crisis. Effective regional arrangements would then improve the effectiveness of the international financial architecture in crisis management and resolution, allowing that the challenges of globalized finance and the country- or region-specific development agenda are better addressed.

Trade

At the Washington Summit, the G20 pledged to refrain from raising new barriers to international trade and investment, a pledge that has sometimes been honored in the breach (Hufbauer, Kirkegaard, and Wong 2010). This pledge was most recently reaffirmed in Toronto, where G20 leaders renewed their commitment to refrain from imposing new barriers on trade in goods, services, or investment, from imposing new export restrictions, or from implementing measures inconsistent with the World Trade Organization (WTO) to stimulate exports. Moreover, they committed to dismantling offending initiatives. And while they reiterated their commitment to concluding the Doha Development Round of global trade negotiations under the auspices of the WTO, they did not provide any timetable or suggest any particular innovative approach or mechanism through which this goal would be achieved.

The most recent analysis by Hufbauer, Kirkegaard, and Wong (2010) suggests that while actual protective measures peaked in the first quarter of 2009, there has not been an abatement of either actual or “pipeline” protection in 2010, and a “second wave” of protection appears poised for 2011. However, some of the protectionist actions were either time-limited and have lapsed or were withdrawn by policy makers. Hufbauer, Kirkegaard, and Wong (2010) construct metrics based on new protection imposed, pipeline protection, major protective policies, tariff line and partner country affected, as well as measures lapsed or withdrawn. On the basis of their composite country rankings, the G20 members that have introduced the most postcrisis protection are Brazil, the Russian Federation, the US, India, and Argentina; the least protectionist are Turkey, Saudi Arabia, the Republic of Korea, Australia, and Mexico. However, they do not construct rankings of “virtuous” countries that have removed protection, insofar as the withdrawal was made possible by original imposition of protection.

Possibly the simplest and most effective means of fighting protectionism would be to successfully conclude the Doha Round negotiations. The conclusion of the Doha Development Agenda has been on every declaration of the G20 summit meetings but any substantial progress remains to be seen (Bark and Kang 2011). Apart from fighting protection, successful conclusion of the round would represent a growth-enhancing structural reform for all participants. Furthermore, as most of the stalemate issues involve disputes among the core members of the G20, not addressing and resolving the disputes could seriously undermine the credibility of the G20 summit as the premier forum for international economic cooperation (Bark and Kang 2011). One possibility

would be to expand the services negotiation, which would hold forth the possibility of inducing greater concessions from advanced countries on agricultural subsidies and related issues.

Another possibility would be to form a G20 group of “Trade Wisemen” to establish an “I know it when I see it” doctrine against new protectionism.³ G20 leaders appear to recognize that protectionist measures concern the world community when they provoke justifiable demands, on the part of trading partners, for emulation or retaliation. To give force to this recognition, G20 leaders should appoint a small group of widely recognized and globally representative trade experts. These experts should be then mandated to spotlight new measures, whether WTO compliant or not, that constitute “protectionism in a political sense” building on the activity of the web-based Global Trade Alert and other such groups.

This group could act as “name and shame” enforcers of the open economy pledges made by G20 leaders in successive summits. If this group had been established in Toronto, the rare earth quotas of the People’s Republic of China (PRC), the Russian Federation’s proposed auto tariffs and extended grain export ban, and the United Kingdom’s immigration restrictions would all be fair game for adverse comment. Pronouncements by the Trade Wisemen can both deter proposed protectionist acts and commend countries that unwind prior protectionist measures. Examples of deserved praise would be India’s removal of its soybean oil import duty and the Russian Federation’s decisions to allow a range of discretionary import tariffs to expire.

This high-profile name, shame, and praise exercise could serve as a guidepost for all WTO members, even if its purview were limited to G20 members. In addition to their periodic pronouncements, the Trade Wisemen could provide useful briefings to trade ministers at summit meetings.

Another possibility could be to establish a regular G20 trade ministers meeting. Trade issues should be brought directly into the G20 process, similar to the manner in which finance ministers meet independently, but alongside their political leaders. To ensure broad representation of the multilateral trading system at regular G20 trade ministers meetings, the director-general of the WTO should serve as the chair. Reports from the Trade Wisemen would give the ministers an independent assessment of global trade conditions. As early as their first meeting in Washington, DC in November 2008, G20 leaders tasked their trade ministers with concluding the WTO’s Doha Development Round, and pledged to “stand ready to assist directly, as necessary” (G20 2008). In these difficult times, trade ministers need all the assistance they can get from their G20 leaders. Tough issues that block the Doha Development Round, as well as fresh conflicts sparked by episodes of protection, invariably involve high politics. Regular G20

³ The phrase “I know it when I see it” was made famous by US Supreme Court Justice Potter Stewart in a 1964 legal opinion, who observed that while he could not define pornography, he knew it when he saw it (and in the case at hand rejected the state’s claim that a film was pornographic).



meetings of trade ministers will ensure that important issues are given due attention and that the trade agenda is not relegated to last place in future summits.

Finally, trade is a critically important factor in economic growth: no country has managed to grow and reduce poverty without access to and the ability to trade. For low-income countries particularly, trade contributes to growth by expanding the market for their goods and services. In the medium to long term, trade further contributes to growth through improved productivity brought about by the import of improved technology, learning-by-doing, and introduction of competition.

But the lack of progress in the Doha Round negotiations augurs for alternative approaches that can be implemented while the round remains stalled. Aid for Trade and duty-free quota-free (DFQF) market access for products from least developed countries (LDCs) are two. Aid for Trade would enhance capacity building, including infrastructure and economic reforms from the supply side in low-income countries, while DFQF market access would increase LDC exports from the demand side.

The personal representatives of G20 heads of governments (commonly known as Sherpas) agreed at their July 2010 meeting in Toronto to include trade and development as one of the main pillars of the G20 Development Working Group, with a particular focus on Aid for Trade and DFQF market access for LDC products. The working group is looking into ways to expand Aid for Trade, as well as to enhance the effectiveness of the approach through better monitoring. In addition, G20 members are preparing to discuss expansion of DFQF market access for LDCs, including the issue of improved rules of origin. These proposed measures are included in the multiyear development action plans, which have been adopted at the Seoul Summit.



Development

The recent crisis highlights the need to secure sustained and balanced growth globally. Although the postcrisis recovery appears to be gaining traction, the world faces daunting challenges of turning this recovery momentum into enduring long-term growth.

At the Pittsburgh Summit, the global leaders clearly mandated the G20 to address development issues, recognizing that reducing poverty and narrowing the development gap are essential to the broader G20 framework of achieving strong, sustained, and balanced global growth. The recent crisis has likely resulted in an additional 50 million people living in extreme poverty (on less than \$1.25 a day) in 2009 and approximately 64 million more people by end-2010 (G20, 2010). While strong growth has been exhibited in developing parts of the world, income inequality and pervasive poverty also remain a real threat to economic, social, and political stability in many emerging market economies.

Emerging market economies have proven to be a strong engine of global growth in the postcrisis recovery phase, although income and non-income development gaps remain large there (Brooks et al., 2010). Unless these development gaps are tackled, achieving sustained and balanced growth will be unobtainable. The key is how to link explicitly development issues to the broader macroeconomic and financial policy framework.

Asia is home to over 2.5 billion people, or 37% of the global total. Sustained high growth in Asia is a necessary element for continued poverty reduction and improved living standards. But a large part of Asia is still struggling with the overarching issue of poverty eradication. Emerging Asian economies will have to stimulate domestic demand—consumption for some countries and investment for others—and redirect the sources of growth from exports to internal demand. Rebalancing Asia is critical to rebalancing the world. While emerging Asian economies have led the recovery process from the recent crisis, their environmental conditions and some social indicators have worsened. Hence, how developing Asia tackles its development challenges holds an important key for the future global economy.

Reforms are under way, but many national and regional challenges remain unaddressed. Ultimately, macroeconomic and financial reforms should support real sector activity, narrowing development gaps and reducing poverty. The 2010 G20 host country, the Republic of Korea,



has both a particular interest in, and potentially insight into, development issues. At the Toronto Summit, the G20 leaders agreed to include development as a key agenda topic of the Seoul Summit and to establish a Working Group on Development to craft a detailed agenda and action plans. Along with measures to promote economic growth and resilience, they were adopted at the Seoul Summit. It is the obligation of the G20 leaders to meet these promises.

Though extremely important, the development issue also carries potential risks for the G20. First, most developing countries are not at the table, so the G20 runs the risk of appearing to dictate policy to unrepresented developing countries either directly or indirectly, through the IMF and the multilateral development banks (MDBs), without proper process. Second, the development issue is multifaceted and challenging, and placing it on the agenda risks drawing attention away from more immediate issues of macroeconomic and financial management. The only way to avoid diluting the importance of development issues while maintaining the momentum of macroeconomic and financial reforms would be to tightly weave the priority development agenda into the main framework of macroeconomic and financial policies.

There is no “one size fits all” formula for development success, however; developing countries must take the lead in designing and implementing development strategies tailored to their individual needs and circumstances. Through an extensive process of consultation, the summit hosts have identified nine key pillars to economic growth and resilience.⁴ This section discusses six of them plus corporate governance, which deserves further consideration.

Human Resources Development

The accumulation of human capital is perhaps the single most critical component of any country’s growth and development strategy. There is a continued need to improve the completion levels and quality of primary education available in many developing countries and to sharpen the focus on employment-related skills gained through enhanced vocational education and job training, though admittedly improving the match between educational curricula and the demands of the job market can be quite difficult, especially for governments with limited resources.

There is scope for G20 involvement, including supporting initiatives that might include (i) creating indicators and monitoring the completion levels and quality of primary education, (ii) assessing the availability and gaps in technical and intermediate level education and vocational training, (iii) fostering ties between institutions of higher education/universities and the business sector in

⁴ The G20 leaders at the Seoul Summit identified nine areas or key pillars that will help ensure inclusive and sustainable economic growth and resilience in developing and low-income countries. These are infrastructure, private investment and job creation, human resources development, trade, financial inclusion, growth with resilience, food security, domestic resource mobilization, and knowledge sharing. See G20 (2010).

low-income countries and G20 member countries, and (iv) sharing best practices on vocational education and specialized job-skills training.

Infrastructure

No country has achieved sustained economic growth without maintaining significant rates of infrastructure investment. Yet over the last several decades infrastructure investment in developing countries has been insufficient. Many countries face severe infrastructure bottlenecks, especially in power, transport, some forms of communications, and digital connectedness.

To promote greater provision of public long-term capital toward developing-country infrastructure, the role of MDBs, particularly in large cross-border or regional projects, should be revisited, as well as the potential for mobilizing public capital through sovereign wealth funds and private capital to finance infrastructure, including through public–private partnerships.

Private Investment and Job Creation

Capital formation is key to expanding capacity and employment opportunities. Private investment, mainly from domestic sources, but also from foreign direct investment, is therefore crucial to generating employment and, by extension, poverty reduction. Yet the outcomes in many developing countries have been disappointing. This suggests the need for a more holistic consideration of the domestic policy environment, which is under the direct purview of local governments, as well as the regional environment, which is not. The latter may be particularly important in the case of small countries, which may have trouble attracting the attention of foreign investors or where foreign investment may be perceived as involving relatively high fixed information or transactions costs relative to larger or more familiar alternatives. The G20 may be able to help low-income countries address such issues as perception of risk, market size, capacity to negotiate with foreign investors, and access to finance, in ways to promote investment and job creation.

Financial Inclusion

More than 2 billion adults do not have access to formal or semiformal financial services. Empirical evidence suggests that improved access to finance is not only pro-growth but also pro-poor, thus making it a means to reduce income inequality and poverty. The Seoul Summit builds on the prior activities of the Financial Inclusion Experts Group launched at the Pittsburgh Summit to address the issue of financial access for small and medium-sized enterprises.

On another note, how to improve remittance flows is one of the key financial development areas for G20 consideration. Today, 180 million people, or about 3% of the global population, live outside their country of birth with most of this cross-border movement accounted for by South–North and South–South migration. Remittances, estimated to be at least \$167 billion in 2005, are a critical component of capital flows for many poor countries. The G20 should address ways to support a reduction in barriers to remittance flows.

Growth with Resilience and Food Security

The G20 should be concerned with ways not only to promote growth but also to sustain it in low-income countries. Empirical evidence shows that most poor countries experience periods of positive economic growth, but these are often subsequently offset by contractions. Low-income countries are generally ill-equipped to deal with unfavorable shocks and volatility, which can arise from a variety of sources including commodity boom–bust cycles and natural disasters. Run-ups in global grain prices have had a particular impact on poor countries, and food security remains a key long-term challenge, as recognized by the G20 leaders at Pittsburgh.

The G20 could make a particularly important contribution by assisting low-income countries in improving their resilience to such shocks. For example, the G20 could support the study and implementation of risk-mitigating instruments, such as weather-based crop insurance. It could also contribute to efforts to improve food security by exerting improved oversight over the relevant public sector organizations, by supporting the promotion of technological advances that boost agricultural productivity, and by encouraging more effective mobilization of private sector resources.

Governance

Extensive research has pointed to domestic institutions of governance as a key contributor to economic performance and successful development outcomes. The effectiveness of all the actions recommended above would be improved with complementary strengthening of governance in areas such as regulatory reform and tax system reform.



Energy and Climate Change

The Lure of the G20 as an Alternative Forum for Climate Diplomacy

The chaos of the December 2009 climate change negotiations in Copenhagen has left many in the international environmental community searching for a new strategy, and a new forum, for advancing climate change cooperation.⁵ In the year since the Copenhagen conference the G20 has been repeatedly floated, both by policy makers and others, as a possible alternative to the existing United Nations (UN) process for advancing climate change cooperation (the UN Framework Convention for Climate Change or UNFCCC). Several attributes make the G20 a seemingly attractive venue for climate change diplomacy, though caveats remain.

Membership

In contrast to the UNFCCC, where all parties have equal voice, regardless of size, and consensus among the full group is required to take action, the G20's exclusive membership allows for more efficient decision making. Accounting for over 75% of global greenhouse gas emissions and the vast majority of the world's mitigation potential, action by G20 countries alone could keep global temperature increases to less than 2 degrees Celsius, at least for the next several decades (**Figure 7**). And in recent years, all G20 members, save Saudi Arabia and Turkey, have announced national emission-reduction targets.

Format

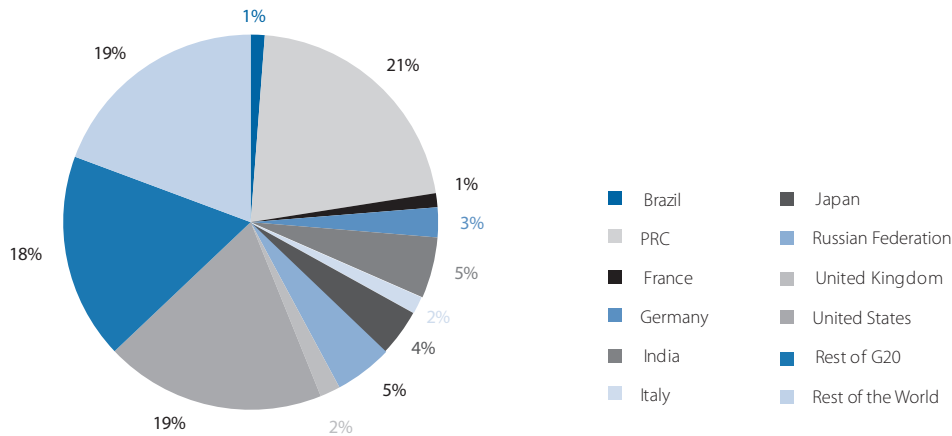
The UN negotiations have been aimed at producing a legally binding climate change treaty. Sharp disagreement over what legal obligations are appropriate for which countries under

⁵ The current United Nations (UN) process charged with implementing the 1994 UN Framework Convention on Climate Change (UNFCCC) has made little formal progress since launching the current round of negotiations in 2007. The UNFCCC's requirement for consensus among all 194 parties to the convention for even routine procedural decisions and sharp differences in countries' core positions resulted in a stalemate in negotiations up to and through the Copenhagen conference. Heads of state from 30 key countries accounting for the majority of global emissions and global population were able to salvage the summit from complete collapse by negotiating the nonbinding Copenhagen Accord. But even this modest outcome was unable to garner the unanimous support required for formal adoption by the UNFCCC. Many parties and observers left Copenhagen wondering whether the UN process will ever be able to deliver a meaningful international solution to climate change if any one country, no matter how small, has the ability to block a deal.



Figure 7 Greenhouse Gas Emissions
(% of world total)

a) Carbon Dioxide Emissions, 2007

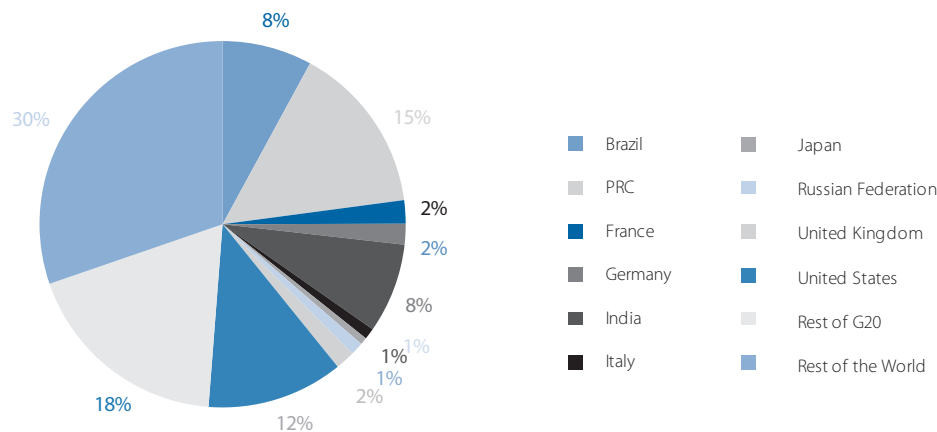


PRC = People's Republic of China; Rest of G20 includes Argentina, Australia, Canada, Indonesia, Republic of Korea, Mexico, Saudi Arabia, South Africa, Turkey, and rest of European Union 27 (Austria, Belgium, Bulgaria, Czech Republic, Cyprus, Denmark, Estonia, Finland, Greece, Hungary, Ireland, Latvia, Lithuania, Luxembourg, Malta, The Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain and Sweden).

Note: Carbon dioxide emissions refer to those stemming from the burning of fossil fuels and the manufacture of cement. They include carbon dioxide produced during consumption of solid, liquid, and gas fuels and gas flaring.

Source: *World Development Indicators*, World Bank.

b) Nitrous Oxide Emissions, 2005

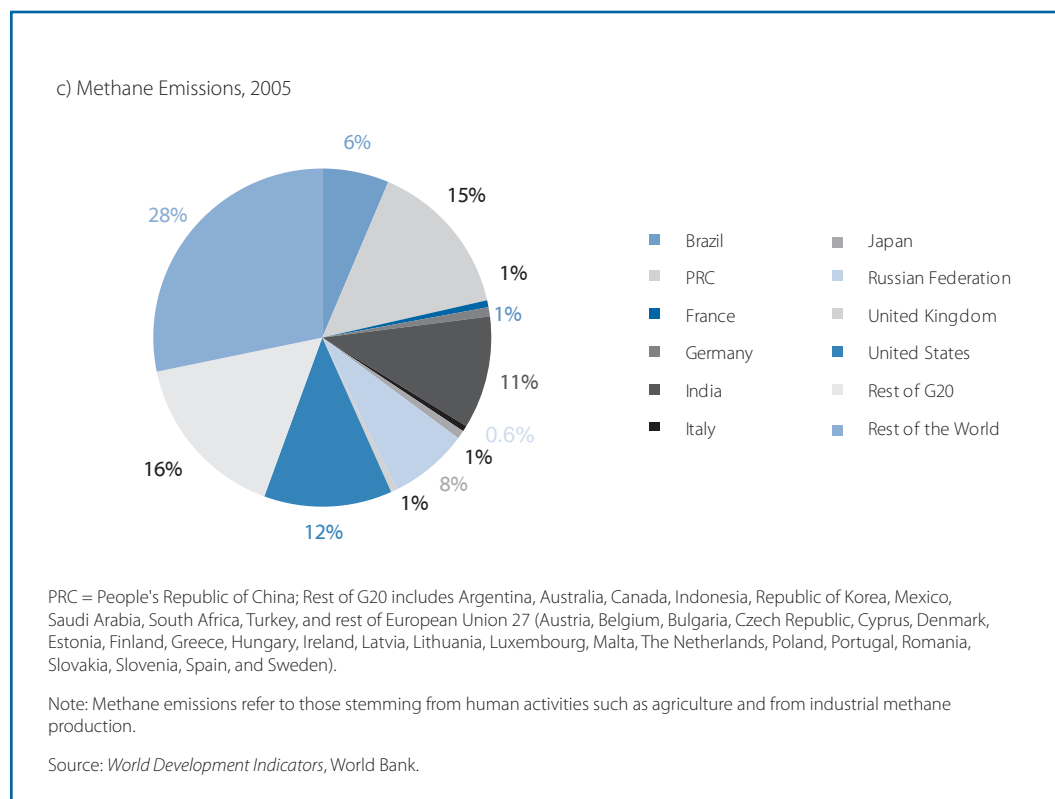


PRC = People's Republic of China; Rest of G20 includes Argentina, Australia, Canada, Indonesia, Republic of Korea, Mexico, Saudi Arabia, South Africa, Turkey, and rest of European Union 27 (Austria, Belgium, Bulgaria, Czech Republic, Cyprus, Denmark, Estonia, Finland, Greece, Hungary, Ireland, Latvia, Lithuania, Luxembourg, Malta, The Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, and Sweden).

Note: Nitrous oxide emissions refer to emissions from agricultural biomass burning, industrial activities, and livestock management.

Source: *World Development Indicators*, World Bank.

Figure 7 continued



such a treaty is a large part of why the negotiations floundered. A five-page political agreement between key countries in Copenhagen (known as the Copenhagen Accord) demonstrated that it is possible to reach agreement on substance in a nonbinding deal. The less formal nature of the G20 could help advance international climate cooperation on a voluntary basis, building on the Copenhagen Accord, until a new legally binding agreement is politically possible. This would help prevent UNFCCC acrimony from hindering efforts to turn fairly positive developments in the domestic policy of most G20 countries into international cooperation and trust.

Expertise

Built on top of a finance ministers' process, the G20 has considerable capacity and expertise when it comes to questions of climate finance, a key pillar of the negotiations. G20 countries also provide the vast majority of both financial aid and foreign direct investment into developing countries at present and will likely continue to do so under any future climate finance regime. Whether identifying potential sources of public financial support for mitigation and adaptation, establishing new international funds, or developing mechanisms to incentivize private investment in developing countries, the G20 could play an important role.



Level and Scope

The Copenhagen conference—officially, the 15th UNFCCC Conference of the Parties—was unique in the number of leaders attending. Future such conferences are unlikely to have participation by heads of state. And while the Major Economies Forum held a leaders’ meeting in 2009, it is unlikely to do so again. As a result, the G20, self-identified as the “premier forum” for international economic cooperation, will likely be the only ongoing plurilateral leaders’ process with both developed and developing countries at the table and a mandate that could extend to climate change. The core issues at play in climate negotiations will ultimately need leaders’ attention to unlock them (as with the Copenhagen Accord) and the G20 could be instrumental in that process. In addition, addressing climate change alongside other G20 agenda items potentially opens up new pathways to a deal not possible in the more narrowly focused UNFCCC setting.

The Challenges and Risks of Putting Climate on the G20 Agenda

While attractive on many levels, however, the G20 also has some significant shortcomings as a forum for addressing climate change. Though the group accounts for the majority of global emissions, it excludes countries most vulnerable to the impacts of climate change. None of the 49 countries the UN categorizes as least developed or the 39 countries that negotiate collectively in the UN as the Alliance of Small Island States has a seat at the table and only one African country (South Africa) is represented. Least developed countries, the Alliance of Small Island States, and the African group are critical constituencies in climate negotiations and any deal struck in their absence would lack credibility and would be widely criticized by those outside the G20 umbrella. This is particularly true on issues of climate finance, as these groups will likely receive the lion’s share of future financial flows.

To tackle the negotiations directly, the G20 would first need to establish a G20+ process for climate change that included representatives from vulnerable country groupings. But getting the right group of countries together will not, in itself, deliver a climate change deal. The fact that six countries—Cuba, Bolivia, Nicaragua, Sudan, Tuvalu, and Venezuela—were able to prevent the 194-member Conference of the Parties from adopting the Copenhagen Accord left many with the impression that the principal impediments to progress in UNFCCC negotiations are the number of actors and the need for consensus. In fact, it is the fundamental differences in the negotiating positions of G20 countries themselves that were at the core of the Copenhagen stalemate.

At its 2010 climate conference in Cancún, the UN demonstrated a greater ability to deliver than most expected. Since no one expected a legally binding agreement to come out of conference, negotiators were free to focus on substance. And with the UN process on notice after Copenhagen, no one had the appetite for another standoff. All 194 Parties, except Bolivia, chose pragmatism over ideology and expanded the Copenhagen Accord into a formal UNFCCC agreement. The technical work now required to implement the agreement is less suited to a G20-like forum, and the UN has regained a great deal of confidence.

Making Progress on Climate through the Existing G20 Agenda

While there is little scope at present for the G20 to take on climate change diplomacy, it can do much to advance climate change action. The existing G20 agenda has the potential to reduce global emissions, accelerate the deployment of clean energy technology, and mobilize public and private finance for mitigation and adaptation. Several areas deserve particular attention and support.

Fossil Fuel Subsidies

In Pittsburgh, G20 countries agreed to phase out and rationalize over the medium term inefficient fossil fuel subsidies. In Toronto, G20 energy and finance ministers presented their plans for fulfilling this pledge. While encouraging, their reports highlighted how much work remains for the G20 in this area.

A report prepared for the G20 ahead of the Toronto meeting estimates that nearly \$557 billion worth of fossil fuel consumption subsidies exist globally and that eliminating them would reduce carbon dioxide emissions by 6.9% in 2020 compared with the business-as-usual scenario (IEA et al. 2010). By comparison, the Copenhagen Accord mitigation commitments would reduce global emissions 7%–13% below that scenario. In addition, the Global Subsidies Initiative estimates that an additional \$100 billion in fossil fuel subsidies exist on the producer side, the phaseout of which would deliver additional emissions reduction gains.

In their reports to the G20, 12 G20 countries offered strategies and timetables for rationalizing and phasing out fossil fuel subsidies, but only three countries—Argentina, Indonesia, and Mexico—included specific plans for eliminating consumption subsidies, but these three countries account for only 24% of G20 country consumption subsidies as estimated by the International Energy Agency (IEA). The remainder focused on the production side. Most countries' plans covered only a fraction of the subsidies landscape.

Part of the lack of ambition can be explained by differences of opinion among G20 countries on the definition and measurement of “inefficient fossil fuel subsidies”—differences that also exist between the authors of the joint report. The mandate of the G20 Energy Experts Group should be extended and expanded in an attempt to address these definitional issues so that G20 members can put forward a qualitative inventory of domestic subsidy policies that is consistent with quantitative assessments of the extent of subsidies in those countries. Only with commonly agreed definitions will the G20 be able to monitor progress of individual members in implementing their domestic strategies and assess the progress of the group in meeting its collective target.

In addition to tracking countries' domestic subsidy strategies, the G20 should identify sectors where coordinated international action will allow for greater domestic ambition. For example, attempts to phase out subsidies to oil and gas producers in country X will likely face domestic



resistance out of concerns that doing so unilaterally will only push production to other countries, making country X more dependent on imported oil. Coordinated action among G20 countries would help address these concerns.

Reform of Multilateral Development Banks

Most multilateral climate finance currently flows through MDBs. Increasing MDB resources and reforming MDB governance have featured prominently on the G20 agenda, in part because of the increased prominence and importance of issues like climate change. At the London Summit held in April 2009, leaders pledged to “make the transition toward clean, innovative, resource efficient, low carbon technologies and infrastructure” and called on the MDBs to “contribute fully to the achievement of this objective.”

The views of MDB board members differ considerably on how to translate these broad pronouncements into project-level decision making. As part of the G20’s broader effort to modernize MDB governance, the group could play a useful role in establishing a more consistent framework for energy and environmental lending to avoid the need for a contentious and public debate on each project. The World Bank, for example, is in the midst of revising its energy and environmental strategies, a process that the G20 could help mold.

Exiting Stimulus

Coordinated fiscal expansion in the face of the crisis is perhaps the G20’s most important achievement thus far. And with energy and environmental issues gaining prominence on domestic policy agendas in most G20 countries, leaders pledged at the London Summit to “make the best possible use of investment funded by fiscal stimulus programmes toward the goal of building a resilient, sustainable, and green recovery.” On the basis of studies by HSBC and the IEA, Houser (2010) suggests that 16% of G20 countries’ 2009 and 2010 stimulus spending went to climate-friendly projects (**Table 3**). This funding has been the dominant driver of domestic energy and climate policy in G20 countries, pushing global clean energy research and development budgets to historic highs in 2009 after three decades of steady decline.

As the G20 discusses when and how to end the current fiscal expansion, special attention should be paid to energy and environmental spending. The G20 has highlighted the importance of policy coordination as countries roll back stimulus programs. This is doubly true for climate-related stimulus programs. Clean energy is a global market and firms will be able to achieve greater cost reductions if the largest markets (G20 countries) can help provide economies of scale through policy coordination. And clean-energy research dollars can go farther when programmed relative to what other large countries are doing. As a result, a coordinated transition from stimulus-driven energy and climate investment to long-term energy and climate policy will provide greater energy security, emissions reduction, and energy cost savings benefits than disparate action.

Table 3 Green Investment in Global Economic Stimulus Plans

Country	Package	Announcement Date	Total Spending (\$ billion)	Period (years)	Green Spending (\$ billion)	% Green
Argentina	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Australia	National Building and Jobs Plan	3 February 2009	26.7	2009–2012	2.5	9.3
	Budget 2009–2020	12 May 2009	17.1	2009–2013	6.8	39.8
Brazil	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Canada	Economic Action Plan	27 January 2009	31.8	2009–2013	2.8	8.7
China, People's Rep. of	National Development and Reform Commission (NDRC) Stimulus	9 November 2008	586.1	2009–2010	200.8	34.3
	Budget 2009	6 March 2009	63.0	2009	17.2	27.3
European Union	Economic Recovery Plan	26 November 2008	38.8	2009–2010	24.7	63.7
France	Revival Plan	10 December 2008	33.7	2009–2010	6.1	18.3
Germany	Stimulus Plan	5 November 2008	104.8	2009–2010	13.8	13.2
Italy	Emergency Package	28 November 2008	103.5	2009 onward	1.3	1.3
Spain	Stimulus Package	27 November 2008	14.2	2009	0.8	5.8
United Kingdom	Budget 2009	22 April 2009	34.9	2009–2011	5.2	15.0
Other EU States	Stimulus Package	9 January 2009	207.1	2009–2010	3.2	1.5
Indonesia	Stimulus Plan	28 January 2009	5.9	2009	0.1	1.6
Japan	Stimulus 2008	19 December 2008	485.9	2009 onward	12.4	2.6
	Stimulus 2009	10 April 2009	154.0	2009 onward	23.6	15.3
	Second Budget	8 December 2009	72.0	2010	7.2	10.0
Korea, Rep. of	Green New Deal	6 January 2009	76.1	2009–2012	59.9	78.8
Mexico	Aggr for Home Economics & Emp.	7 January 2009	7.7	2009	0.8	9.7
Russian Federation	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Saudi Arabia	Budget 2009	23 December 2009	126.8	2009	9.5	7.5
South Africa	Budget 2009–2010	11 February 2009	7.5	2009–2011	0.8	9.4
Turkey	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
United States	Emergency Economic Stabilization Act (EESA)	3 October 2008	185.0	10 years	18.7	10.1
	American Recovery and Reinvestment Act of 2009 (ARRA)	15 January 2009	787.0	10 years	94.1	12.0
	Budget 2010 ^a	1 March 2009	4.9	2010	4.9	
Total			3,202.0		521.0	16.3

n.a. = not applicable

^a Includes only additional spending.Source: T. Houser (2010). A Role for the G20 in Addressing Climate Change? *PIIE Working Paper Series 10-15*. Washington, DC.



At the Pittsburgh Summit, the G20 asked the IMF and FSB to review member countries' exit strategies and provide recommendations for coordination. A complementary process should be set up for energy and environmental stimulus spending. Countries should provide reports at the next G20 summit on the outlook for domestic climate-related public investment, particularly in research and development, given their respective plans for fiscal consolidation. The G20 should then task the newly formed Clean Energy Ministerial (which includes all G20 countries save Saudi Arabia and Turkey), working in consultation with the IMF and the IEA, with developing recommendations for policy coordination. This effort could be coordinated through the G20's Energy Experts Group.

Open Markets

One of the principal G20 objectives following the global financial crisis was to guard against protectionism and support international trade and open markets. In Washington in 2008, leaders underscored the "critical importance of rejecting protectionism and not turning inward in times of financial uncertainty" and pledged to "refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing WTO-inconsistent measures to stimulate exports" over the following 12 months.

Fiscal expansion in G20 countries following the Washington Summit, however, was accompanied by a suite of trade policies that violated this pledge, not least in the energy and environmental space. The crisis, coupled with growing public skepticism about the science of climate change in several countries, has made industrial policy and job creation more important political drivers of clean energy deployment in most parts of the world than energy security or environmental concerns. As a result, there is strong political pressure in many countries to ensure that taxpayer funding for clean energy deployment goes exclusively to domestic clean-technology companies. And while discriminatory trade policies tied to stimulus dollars will fade as countries transition to fiscal consolidation, this emerging "space race" framing of the energy and climate challenge will ensure that protectionism will remain an issue in energy and climate policy making for years to come. Poorly managed, this trend could raise the cost of clean energy technology for all countries and hamper efforts to address climate change.

The G20 should therefore set out to develop a Green Trade and Investment Framework. Such a framework would discipline domestic production subsidies, local content requirements, standards setting, intellectual property rights enforcement, foreign investment approvals, and tariff barriers in G20 countries, helping to ensure that all countries compete on a level playing field in the development and deployment of affordable climate-friendly technology. Many of these issues are currently being addressed in other forums, including the Doha Round, despite the slow progress. The framework would not be a replacement for these processes, but rather a nonbinding approach guiding the domestic policy of G20 countries, which account for the majority of clean energy producers and consumers.

The Perspective from Developing Asia

Global Imbalances

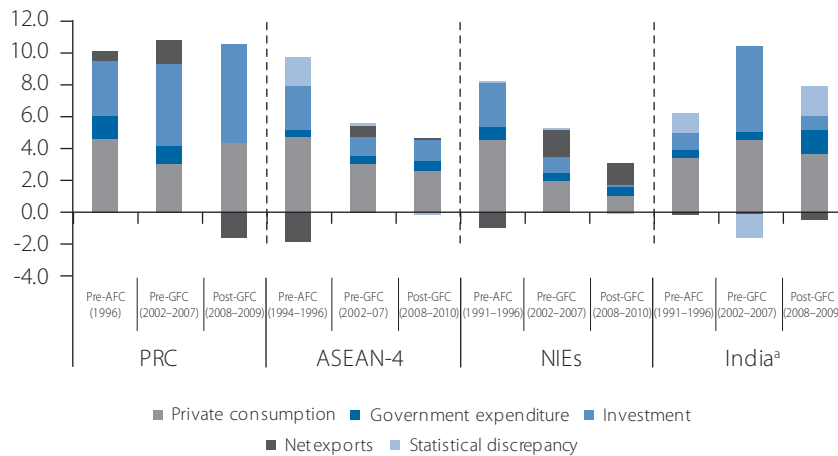
As the most dynamic region in the world, Asia has an important role to play in shaping the G20 agenda for balanced and sustainable growth. This requires Asia to help provide global public goods and to rebalance the global economy. From the Asian perspective, rebalancing translates into two strategic goals: increasing intraregional trade and stimulating domestic demand (see Adams, Jeong, and Park 2010). This is particularly relevant for East Asian countries. In the last few years, the region's trade pattern has been characterized by increased intraregional trade of intermediate inputs, while trade of final goods is mostly with industrial countries. A production network has emerged in a big way, where multinational companies can lower the cost of production by taking advantage of the proliferating free trade agreements (FTAs) in the region.

After the recent crisis, such a trade pattern cannot be sustained; alternative markets need to be found as the demand prospect from industrial countries becomes more uncertain. The alternative that makes sense is the region itself. For export-oriented economies, shifting entirely from external to domestic demand does not make sense, while for other economies, strengthening domestic demand is critical. Raising consumption should be the priority for the PRC, and raising investment is the most important challenge for the rest of Asia. Since early 2000, a major source of growth in most countries except the PRC has been private consumption, not investment (**Figure 8**). This has caused the saving–investment imbalance to widen.

Why the low investment? Since the Asian crisis, most investors in the region have turned cautious and more conservative. The “usual suspects” also persist, i.e., institutional constraints, a less than favorable investment climate, and limited infrastructure. On the other hand, savings remain high and growing. Households in developing economies have strong precautionary motives to save, for, among other reasons, a lack of formal social safety nets. The corporate sector also has a high propensity to save because of various kinds of uncertainties. It is ironic that excess saving occurs when the region badly needs financing for new and improved infrastructure (see ADB and ADBI 2009).

Growing demand in industrial countries and low supply elasticity in the US mean strong growth of exports and continued trade surplus in export-oriented economies. This contributes to the widening

Figure 8 Sources of GDP Growth, by Expenditure Approach—Emerging Asia
(percentage points)



AFC = Asian financial crisis; ASEAN-4 = Indonesia, Malaysia, Philippines, and Thailand; GDP = gross domestic product; GFC = global financial crisis; NIEs = Hong Kong, China; Republic of Korea; Singapore; and Taipei, China; PRC = People's Republic of China.

Note: Aggregates are computed using gross national income (Atlas method, current US\$) as weights. Values refer to period average.

^a Based on constant factor prices.

Source: Staff calculations based on data from various issues of ADB *Key Indicators*, CEIC, *China Statistical Yearbook 2009*, national sources, and World Bank *World Development Indicators*.

of global current account imbalances. In terms of size, the imbalance is largest between the US and the PRC. Trade of the PRC with other Asian countries is generally in deficit, while imbalances of Asia excluding the PRC with industrial countries and the US are relatively small. Thus, the role of the PRC is critical as far as Asia's contribution to global imbalances is concerned.

An easy money environment was one of the important sources of global imbalances that fueled the recent crisis.⁶ The fear of deflationary pressure associated with falling asset prices after the Asian financial crisis, the tech bust in 2000, and the looming Iraq war prompted the Federal Reserve to adopt an accommodative fiscal and monetary policy that caused not only excessive spending and a credit boom, including one in the housing market, but also raised US imports, particularly from Asia (Azis 2009). This exacerbated the already large US current account deficit caused by the growing fiscal deficit, especially since early 2000. The resulting

⁶ In its final report, the congressional commission of 10 members formed to investigate the causes of the crisis concludes that it was the result of "human action and inaction, not of Mother Nature or computer models gone haywire." The report clearly singles out the Federal Reserve for backing "30 years of deregulation." The report also points out that the IMF did appropriately stress the urgency of addressing large global current account imbalances that risked triggering a rapid and sharp decline in the dollar that could set off a global recession, although it failed to link these imbalances to the systemic risks building in financial systems (FCIC 2011).

appreciation of Asian currencies—albeit not all are fully flexible—and lower returns in industrial countries brought most capital back to Asia. Hence, a round-tripping pattern was established with high transaction costs. Market intervention by most Asian authorities then caused further accumulation of foreign reserves.⁷ From this perspective, to deal with global imbalances, policies directed toward lowering the US fiscal deficit are as critical as other measures.

During the crisis, global current account imbalances actually narrowed as world trade volume also fell. Asia contributed to this encouraging trend: trade began to diversify, with intraregional trade expanding to include more Asian countries, while exports to non-Asian emerging markets increased as well. The current account surplus in many countries started to fall, and the largest source of growth was domestic demand. The PRC's 12th Five-Year Plan also put a strong emphasis on rebalancing demand toward domestic sources, particularly consumption. There is, however, no reason to believe that this trend of declining global imbalances will continue. The growth of global trade, which showed a V-shaped recovery in 2009–2010, has started to slow. Many forecasts also predict that global imbalances are likely to grow in the coming years (IMF 2010c). This is worrisome because the current recovery in many countries is fragile. From the recent crisis we have seen the severe damage that growing imbalances can create.

Rising oil prices raise further concerns, although G20 can actually resolve this matter in a more coordinated way since its members include both the world's largest oil producer and world's largest consumer. During the past decades we have seen several episodes of oil price increase and their impact on the world economy. Unlike in the past, however, the surge of oil prices that began in the fall of 2004 did not result in a major economic slowdown; at least not in any of the G20 countries. In oil-importing economies, the demand-driven nature of the oil price shock counteracted its adverse repercussions.⁸ But the impact of the current oil price increase may be different. It may be more serious because many economies have just started to recover from the most severe crisis since the Great Depression, and because the recovery in Europe and the US is still fragile.

For poor Asian countries, this adds to the seriousness of the problem, since they are also struggling to cope with the rising food prices that raise poverty and malnutrition rates. Ironically, in many agriculture-based economies, rising food prices do not necessarily translate into higher incomes of farmers, that is, the farmers' terms of trade do not improve. While there may not be much that can be done to deal with the supply-side shock (weather-related), a policy reform in food production and distribution that will ensure the pass-through of food price increases to farmers' income can be proposed as part of the G20 development agenda.

⁷ With rising costs of keeping a large amount of reserves, some Asian governments set up and use government-controlled investment companies to manage a portion of official foreign reserves to adjust portfolio composition.

⁸ Most countries in Asia are net and oil importers, intensive in energy use, and are relatively inefficient in energy use; in some countries, however, the share of oil in total energy use is not that large.



Intraregional Trade and Exchange Rate Cooperation

The impact of a sharp fall in world trade during the crisis was particularly severe in export-oriented economies such as Japan, the Republic of Korea, the PRC, Malaysia, Singapore, and Thailand. Industrial countries including the US are important markets for their final goods exports, whereas intermediate goods are imported from other Asian countries. This pattern of trade has been one of the characteristics of the production network that has spread across East and Southeast Asia.⁹ Although industrial countries made assurances during the London Summit that they would keep their markets open, it would be ill-advised for Asia to continue relying on markets in industrial countries for their final goods exports. With demand falling from the slow-growing industrial countries, intraregional trade in final goods is expected to increase. It is therefore important for the region to dismantle any barriers to intraregional trade.

A scenario where PRC consumers can take up lost US demand for products from Asia is unlikely in the short run. Freer trade among Asian countries is the only reasonable solution that will simultaneously deal with the problems of global imbalances. Here, the proliferation of FTAs among Asian countries is helpful.¹⁰

No less important is the stability of intraregional exchange rates. Evidence has shown that stable intraregional rates can help foster intraregional trade. After Lehman's collapse, interregional rates started to become more volatile and intraregional trade fell (**Figure 9**).¹¹ External forces that are also at play caused volatility to continue. The second round of quantitative easing by the US Federal Reserve, aimed at preventing a possible deflationary spiral at a time of fiscal policy paralysis, is adding more pressures for capital to flow out from the US. Even before this second round was announced, interest rates in the US and other industrial countries were already low, triggering a wave of capital outflows. A substantial amount of these flowed into emerging Asia with its high returns, robust growth, stable macroeconomic conditions, and strong currencies. As shown in **Figure 10**, after dipping sharply during the crisis, capital has returned to the region. Even in net terms, the trend in ASEAN-4, the newly industrialized economies, and India showed a marked increase of inflows right after the crisis.

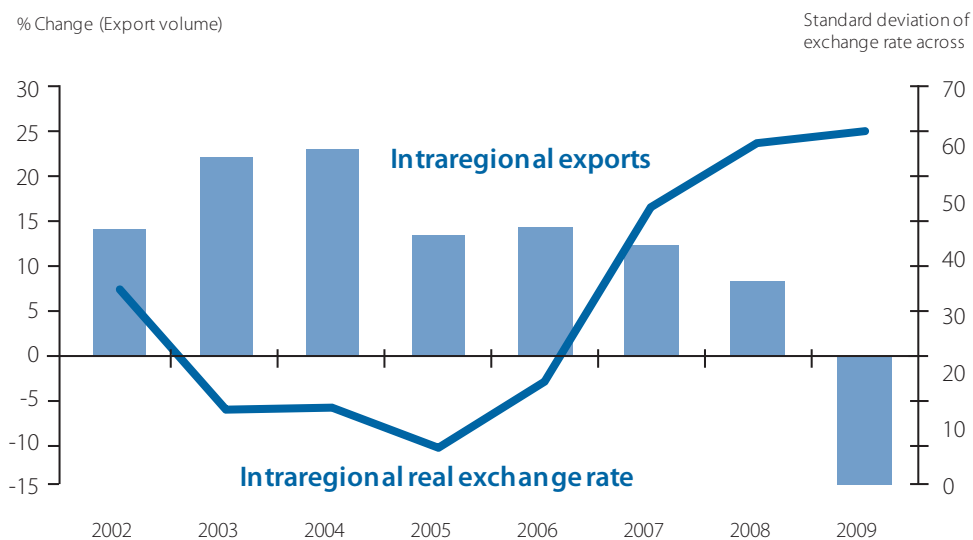
While the composition of capital flows varies across countries, rising portfolio investment puts strong pressure on exchange rates. The resulting dollar depreciation (Asian currencies' appreciation) led many countries to respond by either imposing capital controls or conducting

⁹ This production network has played an important role in forging the region's productivity.

¹⁰ Some agreements that cover all Asia are still elusive, and in some cases the pace of implementation remains questionable.

¹¹ Greater intraregional exchange rate stability can also help reduce policy tension. It is, however, to the region's advantage if flexibility of their currencies against non-regional currencies is maintained. The flexibility is important for managing external shocks and further capital flows.

Figure 9 Intraregional Exports and Exchange Rate—Emerging East Asia

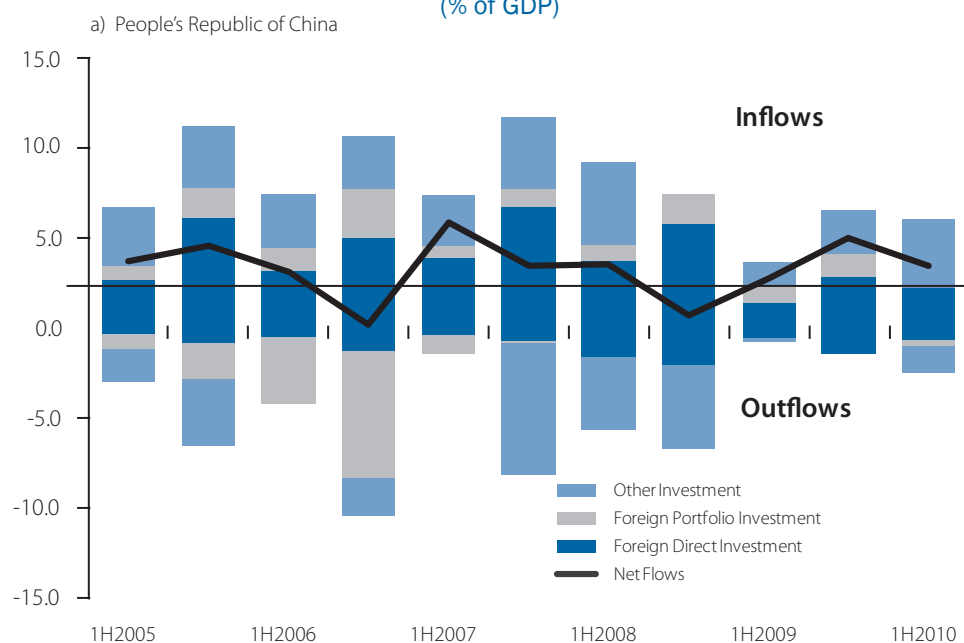


Emerging East Asia = Brunei Darussalam; Cambodia; People's Republic of China; Hong Kong, China; Indonesia; Republic of Korea; Lao People's Democratic Republic; Malaysia; Myanmar; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.

Note: The standard deviation of exchange rate is computed across countries and weighted using total trade (at constant 2005 US\$ prices). Intraregional real exchange rate against the Asian Monetary Unit (ASEAN+3 including Hong Kong, China) was used. It does not include Taipei,China as data were unavailable.

Source: Research Institute of Economy, Trade and Industry (RIETI), Japan for real effective exchange rate; IMF *Direction of Trade Statistics* for exports; IMF *World Economic Outlook Database* and national sources for domestic and foreign income, and consumer price indexes; and World Bank *World Development Indicators* for gross national income.

Figure 10 Financial Account Flows (% of GDP)



Source: OREI staff calculations using data from the International Monetary Fund and national sources accessed through the CEIC database.

Figure 10 continued

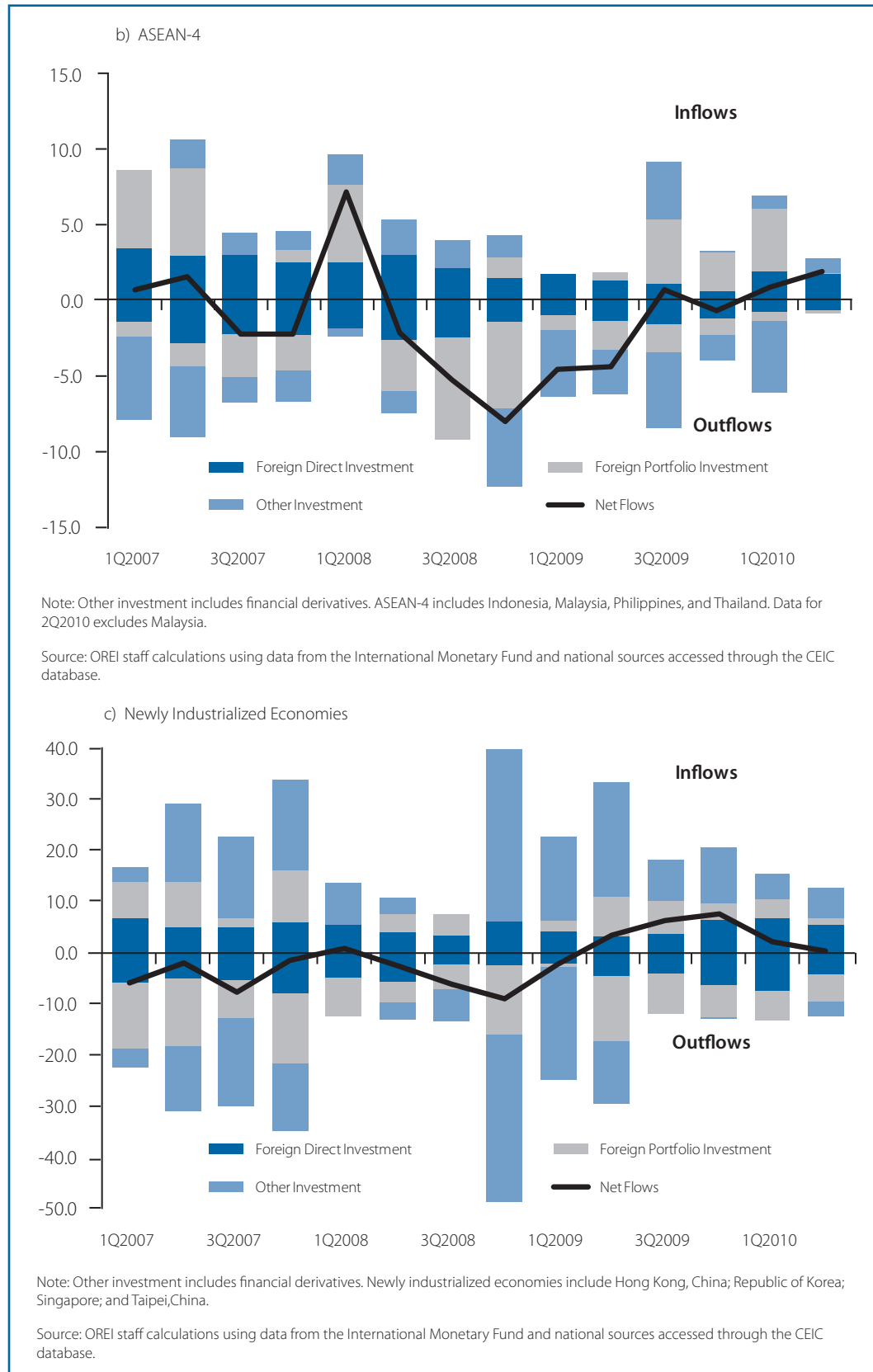
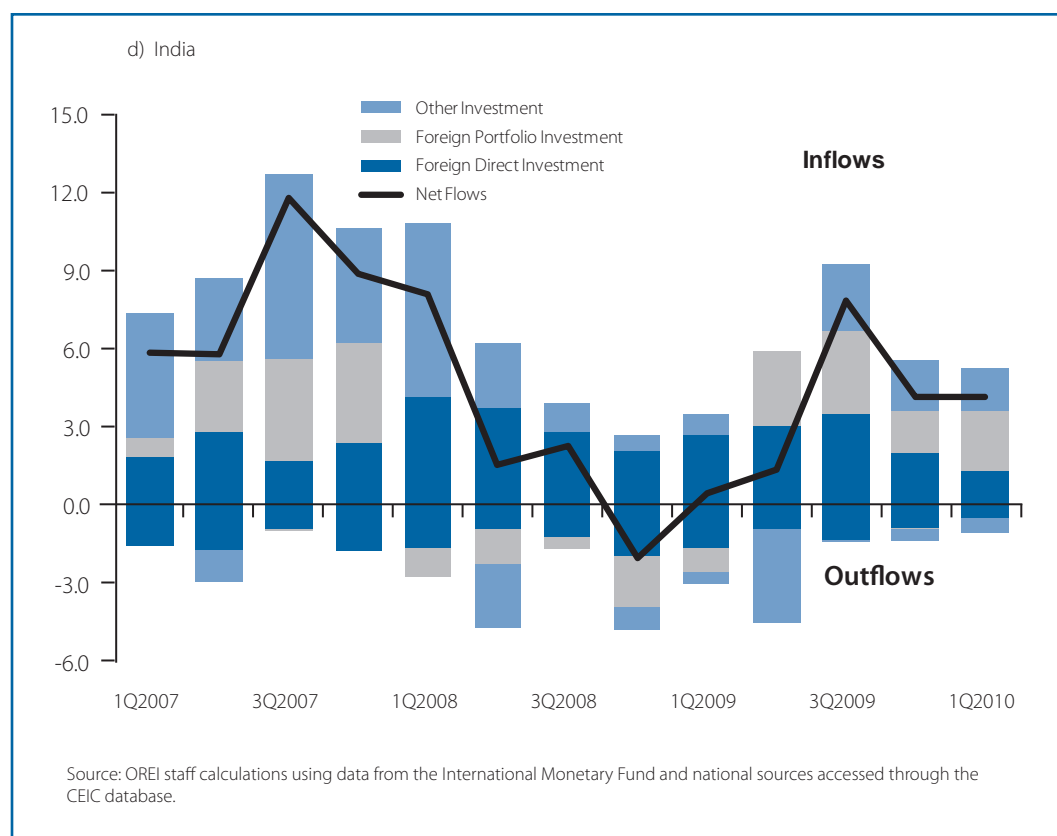


Figure 10 continued



exchange rate intervention. This makes efforts to maintain stability of intraregional exchange rates more difficult, but at the same time it opens up the possibility of policy coordination. Indeed, some countries in ASEAN+3, supported by the ADB, have initiated a series of discussions and policy dialogues on this issue.

The spillover effects of unilateral capital control, and awareness that it can potentially create distortion, also reinforce the need for cooperation. The fear of a sudden stop (as in 1997) is another source of concern. But the difficulty in finding an acceptable modality of cooperation due to the diversity of exchange regimes and associated political sensitivity may have put off any formal arrangement from emerging. A classic case of the prisoner's dilemma thus prevails.

Because the PRC's trade balance with most ASEAN countries is in deficit, a scenario of simultaneous exchange rate adjustment through cooperation will also make the realignment of the yuan easier. It may be more effective than pressuring a country to adopt a particular exchange system. Indeed, economists are not always in agreement as to what exchange rate system is best to adopt. While globally there has been a trend of increasing number of floaters, it remains unclear how to determine the extent to which a currency deviates from its equilibrium level.



Appropriateness of a particular regime depends on each country's conditions. The exchange rate system in Asia is diverse, ranging from a floating Japanese yen to a currency board system in Hong Kong, China (others are in between). Equally ambiguous is the precise definition and level of equilibrium exchange rate. While some currencies may be undervalued, the type and the extent of intervention considered acceptable remains a gray area. In the past, the IMF often supported efforts made by industrial countries to coordinate their monetary and fiscal policies that could alter the exchange rate in the name of maintaining global financial stability.¹²

While exchange rate cooperation is warranted, Asia is likely to shy away from a strong form of cooperation or other forms that require strong institutions (such as monetary union or common currency). The recent sovereign debt crisis in Europe made the benefit of having such arrangements doubtful. Also, Asia does not have a good track record of institution-heavy economic cooperation.¹³ But there is still a whole spectrum of options to select, ranging from a basket system that can be designed to avoid the “N-1” problem, to Bretton Woods–like systems where countries directly peg their currencies to each other and let them float jointly against other currencies, say, the US dollar (similar to what happened in Europe before a common currency was adopted and managed by a supranational body, the European Central Bank). The rates against a regional basket such as the Asian Monetary Unit (AMU) can also be used as a reference zone, certain deviations from which will trigger some policy measure. The lightest form of arrangement would be simply to enhance policy dialogue among member countries, for example through the existing Economic Review and Policy Dialogue forum. After the Chiang Mai Initiative was multilateralized in early 2010 (to become CMIM), finance ministers of ASEAN+3 made a decision to establish an independent surveillance unit, the ASEAN+3 Macroeconomic Research Office. This marks the region's first step toward institutionalizing financial cooperation. It is likely that exchange rates and capital flows will be part of that office's surveillance analysis, along with other macroeconomic issues.

Another related source of concern is the declining value of the US dollar. Many Asian countries worry that rising commodity prices and a soaring US deficit to pay for stimulus can lead to higher inflation that will undercut the value of their US dollar-denominated reserves. The PRC and Japan are the largest holders of US Treasury bills. No wonder that on several occasions PRC officials questioned profligate US spending habits. It is in this context that ideas were floated that Asians either need their own currency or should adopt a currency basket to replace the dollar. Actually such a proposal was raised right after the Asian financial crisis, but the recent trend may have strengthened its rationale—and it may quicken the process. Looking at currency movements in selected Asian countries, over the last few years reliance on the dollar has been declining,

¹² At least the IMF does not place any obligations on those countries when they conduct such efforts.

¹³ Even during the recent crisis, the Chiang Mai Initiative was not used.

and the role of other currencies, including the yen and yuan, has increased. This occurred without any announcement about a basket system. But to move to the next step, closer policy coordination is obviously needed.

Through the G20, Asia can learn from the experience of other G20 countries—in Europe in particular—in policy coordination and exchange rate cooperation. By realizing the differences between the two sets of economies, lessons can be learned as to what policy direction to take, what not to take, and what needs to be done. The speed and nature of each stage and the components of cooperation can be studied, and when found relevant to the Asian context, they can be emulated.

Domestic Demand and Interactions with Development Issues

From Asia's perspective, giving a more prominent role to development issues in the G20 agenda, as decided at the Seoul Summit, is commendable. One of the G20 development initiatives highly relevant for Asia is financial inclusion. Through the Financial Inclusion Experts Group, nine Principles for Innovative Financial Inclusion were announced at the Toronto Summit. The principles, from leadership to regulatory framework, are intended to form the basis of a concrete action plan for improving access to financial services for the poor, details of which were released at the Seoul Summit. Two broad agenda have been selected: access through innovation, and finance for small and medium-sized enterprises.

But G20 also covers other development issues, many of which are relevant for Asia as well. Most governments in Asia realize the need to strengthen social safety nets, including pension and health insurance programs; speed up the development of physical infrastructure to reduce supply bottlenecks; and raise investment for more sustainable long-term growth, such as energy efficiency, renewable and clean energies, green transportation, and quality-of-life services (health care and sanitation). All these are not inconsistent with rebalancing. Strategies have been discussed and designed, measures have been taken, and some may not be the most optimal and their implementation may face many bottlenecks, especially when macro and fiscal policy is inconsistent with more development-oriented measures such as these. Still, any strategies and policy measures (including those directed toward lowering global imbalances and mitigating their impact) ought to be linked with the ultimate goal of welfare improvement. The effectiveness of those policies needs to be evaluated based on indicators that go beyond the narrow macroeconomic and financial sector.

Indeed, while development issues are diverse and by themselves deserve attention, little has been done to understand the interactions between these issues and macro, financial, and trade measures in the context of Asia's efforts to rebalance. Thus, exclusion of the poor and small and medium-sized enterprises from financial services, issues of the environment and climate

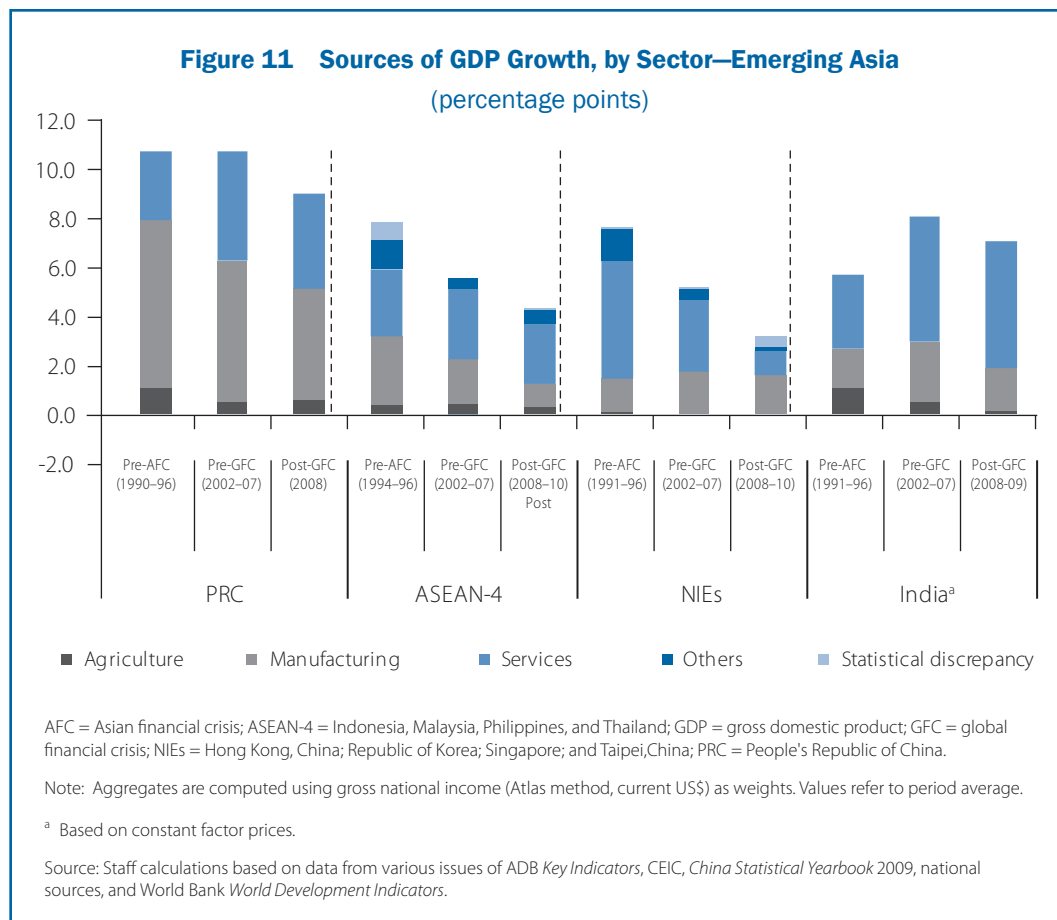


change, income inequality and poverty—all of which are so critical in many G20 countries—should not be seen only as the consequential impact of macro-financial measures that will be subsequently countered by some compensating policies (such as financial inclusion). Yet this practice is common, instead of attempts to reassess the respective macro-financial policy and explore an alternative that will ensure inclusion.

Interactions imply two-way directions. A proactive rather than reactive approach suggested above is not only preferable in terms of cost-effectiveness, but it can also preclude any possible negative feedback effects. For example, a deteriorating environment due to an unsustainable pattern of development in many Asian countries can have an adverse impact on the supply and productivity of many sectors in the economy, and it can contribute to the increase of food prices, commodity prices, and inflation in general. Rising inequality across any country in Asia is likely to have an adverse impact on growth, hence its sustainability. The mechanisms of this can work through at least three channels: uncertainty caused by greater social instability, insecurity due to lack of property rights, and rent-seeking practices that can raise transaction costs and so dampen growth. Although the impact may not be felt in the short run, when output growth falls, so will household income, including those in the low-income bracket. When inflation rises and a food crisis looms, poverty incidence tends to increase.

Excess saving and the link between financial sector development and broader development issues is another noted example. According to flow-of-funds data, most countries in Asia have excess saving in the sense that total saving exceeds actual investment in the real sector. This excess largely goes to financial assets, both abroad (foreign reserves in US treasuries) and at home (equity, bonds, and other securities). As a result, economic growth is strongly supported by a growing financial market. This is also consistent with the information from national income accounts where the financial sector is recorded as one of the major sources of growth, along with domestic trade and other services (**Figure 11**). Except during the Asian financial crisis, this pattern has been persistent and self-reinforcing, as incentives to invest in financial assets continue to exceed those to invest in the real sector. Although this may foster overall growth and financial sector development, it fails to provide sufficient employment opportunities. This can spell trouble in some countries in Asia where the labor force is growing fast. Consequently, an unchanged rate of output growth creates much less employment now than in the past (declining employment elasticity). The same applies to poverty reduction (declining poverty elasticity).

Thus the challenge for Asia is how to channel the excess saving toward more productive investment in a manufacturing sector that will generate jobs, since this is generally more employment-creating than services in general. This is why improvements in the business and investment climate are so important. From this perspective, efforts to raise domestic demand are not only necessary for lowering global imbalances, but for many Asian countries they are also warranted to make development and growth more inclusive (Zhuang 2009).



Indeed, the growth pattern in many Asian countries has been far from being inclusive. While the region has done relatively well in terms of output growth and macroeconomic management, even during the recent crisis, the development and welfare outcome has not been good. In many countries environmental conditions have worsened, resource depletion has become alarming, unemployment (especially among youth and the educated segment of the labor force) has increased sharply, and income inequality has risen almost across the board. To be credible and accepted by the global community, G20 needs to assume leadership in this area. It should encourage policy makers to seriously reassess the development pattern that has produced unfavorable outcomes. In particular, focus ought to be directed toward the interactions of these issues with the strategy and policy approach needed to lower and mitigate global imbalances. This is the only way to achieve “strong, sustainable, and balanced growth”—the stated goal of G20.



Global Role and Governance

In Chinese, the word “crisis” is made up of the characters for “danger” and “opportunity.” From Asia’s perspective, the G20 should see the recent crisis as these two things. The fact that the global recovery is “strengthening, but is still uneven” and that the international monetary system has proven “resilient, but vulnerabilities remain” indicate that the work is only half done. Emerging economies have become important forces in helping the world to weather the crisis, and this highlights the importance of the G20. Indeed, the G20 has done remarkably well in helping the global economy to recover. It has emerged as the leading forum for coping with the crisis. But the unevenness of the recovery and the persistent vulnerability in the global financial system remain serious challenges. Financial regulations have been strengthened but are still far from sufficient to avert a similar shock in the future, especially when “too big to fail” problems remain. Many components need further structural changes, especially those related to the least regulated financial instruments. For Asian countries, the lesson of the Asian financial crisis is clear—that a too liberalized financial sector not supported by proper regulation and supervision is a recipe for disaster. Whether the world economic structure of the past, as characterized by liberalization and deregulation, can realize a smooth transformation of the global economy to achieve more sustainable and balanced growth with minimum risk of crisis, depends on how far the G20 can help to push reforms of the international monetary system. The recent crisis should be seen as an opportunity to push such moves.

The unevenness of growth and the difficulties in achieving more significant finance sector reform present another difficult challenge as it touches on the issue of power influence. The role of the IMF in reporting the vulnerabilities prior to the crisis is a notable example. Despite the IMF’s warning, officials from powerful industrial countries concealed such important information and put pressure on the IMF to tone down warnings before the crisis. Often the IMF wilts in the face of officials’ demands to water down criticisms.¹⁴ One cannot imagine that being true for developing and emerging countries. The extent to which the G20 can balance the influence between the developed world and emerging economies is a major test for the future development of this global forum. Another critical test is whether it can properly handle its relationship with non-G20 countries.¹⁵ Unless it listens and caters to their claims and respects their interests, its legitimacy—and perhaps its existence—will be seriously questioned.

Asians are coming of age. In formulating the strategy to support its agenda, the G20 can absorb the experience in Asia that may provide lessons to be shared, both good and bad, on macroeconomic and development policies. In addition to providing financial resources, Asian members of the G20 can also play a greater role in helping to set the vision and ambitions

¹⁴ Revealed in a report by the IMF’s Independent Evaluation Office (IEO) in January 2011. In some cases, according to the report, so intimidated were the IMF staff that they did not challenge the officials’ arguments. See IMF 2011.

¹⁵ G20 member countries only account for 10% of more than 200 states that engage in global economic activity.

for global rebalancing, and to share Asia's unique experience in areas such as establishing international production networks, and using the government and public sector to play a vital role in supporting these networks.¹⁶ In the global financial reform, Asia should no longer be content to leave it to powerful industrial nations to decide; it must join in setting new standards for global financial institutions and in regulating risk. Regional or subregional arrangements can be used to facilitate Asia's stronger voice and sense of ownership.

The new global economic governance structure will need to be based on representative institutions that reflect the changing economic weight of emerging economies in the global economy. Asia should and will play a greater role on the global stage.

¹⁶ The way the region looks at the importance of investment and the necessary infrastructure, beyond just trade, by establishing international production networks is acknowledged by many countries and institutions, including the Inter-American Development Bank. It suggests that Asia has a unique track record in establishing such production networks. Asia also has much to offer in terms of resources management, innovative financing, technical expertise on engineering and design, and project management.

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Reshaping Global Economic Governance and the Role of Asia in the Group of Twenty (G20)

This report, jointly prepared by ADB and the Peterson Institute for International Economics, aims to provide strategic guidance for emerging Asia's participation in the G20 and related discussion about reform of global economic governance. The recent global financial crisis underscored the fact that the spirit of cooperation is key to successful reform. Without tighter coordination between old and emerging powers, it will be hard to find lasting solutions to pressing global problems. The rise of emerging market economies heralds a new world order. Yet consolidating the new voices and soliciting a sense of ownership from them pose a real challenge. This report draws on important lessons from the crisis to offer policy recommendations in areas of imminent challenge confronting the leaders from both old and emerging powers.

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