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The G20 and recovery and beyond: An agenda for global governance for the twenty-first century

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Jean-Paul Fitoussi, Joseph E. Stiglitz
and the Paris Group

THE G20 AND RECOVERY AND BEYOND

AN AGENDA FOR GLOBAL GOVERNANCE FOR THE TWENTY-FIRST CENTURY

OFCE & LUISS

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FOREWORD

The G20 is at a critical juncture. Either it moves forward shaping the way of a new, more effective, global governance or it will become just another Gn where discourses and solemn declarations take the lead over action. There is nothing wrong in multiplying for where heads of states and governments meet all over the planet. At the contrary exchanges of views on common problems and the ways they are appraised in different countries may “à la longue” affect the design of national policies.

But, on one hand, after the crisis the G20 gave rise to high expectations, which were almost met at its first meetings and, on the other hand, the problems facing the world today are more urgent than ever, especially those which need a persistent action to be resolved because they are of a long term nature (development, climate change, inequalities, investment in democracy, to name a few).

The danger the world is facing today is that countries, forgetting that their economies are strongly interdependent, are “renationalizing” their economic policies, acting as if each of them were confronted with specific problems whose solutions were without externalities for the other countries. The paradox of the situation is that the feeling of urgency is disappearing at the very moment where the problems are becoming more urgent, especially if we want to avoid both a “remake” of the crisis and an acceleration of the destruction of a number of global public goods. The responsibility of the G20 is thus considerable. It could act in such a way that would allow us to get out of this situation, creating a future where growth is more sustainable, friendlier to the environment, and where its fruits would be distributed in a more equitable way, both within and among countries. Otherwise, it will bear the responsibility before history of not having done the duty which has been delegated to it, despite having been in exceptional circumstances that gave it much more room for manoeuvre than it would have had in 'normal' times.

That is why a group of 'experts', with no commitments other that of being citizens of the world, decided to meet to reflect on what could be done, hoping that from their reflection some useful recommendations to the powerful of this world would emerge. This group, which christened itself the Paris Group, has been constituted at the invitation of the President of The French Republic, who also presides over the destiny of the G20 this year. The Chairmen were given complete discretion in the choice of the membership of the group; their sole responsibility was to gather a diverse group of individuals with the highest level of expertise in the subjects confronting the G20 and with a commitment to working to ensure the improvement in the system of global economic governance.

The chapters which follow contain a summary of the discussion between the members of the group and the preparatory notes which have been written by them.

Jean-Paul Fitoussi & Joseph E. Stiglitz

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PART I

CHAIRMEN'S SUMMARY

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The following summarizes discussions and recommendations to the President of the French Republic on the G20 agenda of a group of economists representing Asia, Europe, Latin America, and the United States, experts in virtually every arena of economics, from academia, finance, government, and business (all, though, in their private capacities). The members of the group have been selected freely by the chairmen and there is a significant overlap between the composition of this group and that of the UN Commission of Experts on Reforms of the International Monetary and Financial system. The meeting of the group was hosted by the Ministry of Economy, Industry and Employment at Bercy in Paris on the 5th of January 2011. The group met on the 6th with the President of the French Republic during a working lunch in order to report its main conclusions and to openly discuss them.

The Urgency of the situation

The G20 is at a critical juncture. The G20 enjoyed enormous success in the response to the global economic crisis in late 2008 and early 2009. The crisis *was* managed, and it was far from obvious that this would be the case, especially given its severity and the prevailing doctrines in 2008, which had in fact contributed to the crisis and its rapid spread around the world. This was the crucial difference from the 1930s. In the heat of action, dogmas that held back intervention were dumped much more quickly. It was even understood that, in direct contrast to the policy of non-cooperation adopted in the inter-war period, what was needed was the best possible coordination at the global level, even if the institutions involved

in delivering a response had weaknesses or lacked legitimacy. The years 2008-2009 were thus marked by the rising influence of the G20 and the relative decline of the G8, as well as by a growing awareness of the need for governance that is truly global. In short, there was a global crisis that required a global response and the G20 helped to give it: cooperative actions to undertake strong stimulus and to avoid protectionist measures helped avert turning the crisis into another Great Depression. Since then, though, the sense of cohesion has evaporated. The early successes of the G20 were based on a shared vision and shared interest: the entire world faced the common threat of recession/depression, and there was a common understanding that the only way to combat the downturn was strong government action, both to save the banks and to stimulate the economy. Since then, though, marked divisions in circumstances and perceptions have arisen; some countries, mainly emerging countries, have returned to robust growth, others are mired in high unemployment. Some countries face financial constraints, forcing austerity measures. But among countries not facing such constraints, some are nonetheless choosing austerity, in the belief that such policies will restore growth; while others argue that these policies will delay full recovery. Some in the developed countries argue that policies in emerging markets are promoting growth in those markets at the expense of jobs in the developed countries; others that the policies in the developed countries aimed at restoring growth there threaten to cause bubbles and instability in the emerging markets, and that strong and stable growth in emerging markets are beneficial to the developed countries. With such divergences in circumstances and perceptions, it is hard to develop concerted policies. Moreover, there are those who might benefit from the failure to achieve concerted action: many in the financial market prefer the current situation with weak global financial regulations.

It is perhaps not a surprise, then, that some more recent meetings have been a disappointment. If there are not some successes under the French Presidency, the relevance of the G20 will come to be questioned. Under the circumstances described above, agreements based on the least common denominator are likely to be viewed as disappointing—not up to the tasks facing the world.

There are many factors that may explain the loss of cohesion among countries, cohesion that seemed so strong in 2008-2009. Among them, two are of particular importance in view of their possible impact on the design of future policies. The first is the growing emphasis that is put on the sustainability of public debts (even by those countries that have a sound public finance situation), which as a consequence of the crisis have

increased sizably almost everywhere. The second is the shift of emphasis from the demand to the supply side of the economy through competitiveness concerns. The combination of both factors is increasing the inward-looking character of national policies and thus their non-cooperative potential. Part of this evolution is actually doctrinal in nature. The slogan "cherchez le supply" which was at the heart of the pre-crisis doctrine is being rejuvenated. Devotees of this doctrine—who kept silent during the brief return of Keynes on the political arena—are again raising their heads, accusing governments of extravagant spending and of having amassed unsustainable debts. The word Keynesian once again carries a negative connotation, especially in Europe.

What can be done?

The Group focused on what it considered to be the central economic issues: the current macro-economic situation, reforms in the global financial and monetary system, climate change, financial sector reform, development and global governance. In each area, it asked: (a) Are there broad *visions* for the future directions of the global system upon which there can be consensus? (b) Are there some instances in *processes* can be initiated that bring some aspects of the vision into reality? (c) Are there some current *actions,* even of limited scope, upon which there can be some agreement?

As the discussion that followed evidenced, there was unanimity (or near unanimity) among the group in several areas—a broadly shared consensus—and yet, in the past, the governments of one, two, or three countries have raised objections, preventing meaningful progress. In some of these instances, it may be possible to devise compromise solutions. In others, this will not be possible. It is always difficult to persuade countries that it is what is perceived to be in the global interest is in fact in their national interest, even when it may appear not to be. Of course, the rationale for global cooperation is that when there are important externalities, it may *not* be in each country's interest to narrowly pursue its own shortsighted self-interest; the equilibrium that results from each country doing that is inefficient—and this is why there is a need for global collective action.

The G20 cannot let the principle of unanimity lead to paralysis. Rather, as it recognizes that there may be such instances, it should also acknowledge that sub-groupings should nonetheless proceed in coordinated and cooperative actions, with arrangements that are *open* to the adhesion of others, but with the broad understanding that others would not be *coerced*

to join. Such initiatives are already occurring, mainly around regional blocs. But there are common interests that extend beyond a region, and the G20 can be an important venue for exploring such initiatives. One might expect that the success of these initiatives will put peer pressure on others to join in these cooperative actions.[1] After a "club" is constituted, the advantages of joining the club are likely to become more obvious.

The crisis itself had called into question many longstanding and widely held beliefs (which, however, were never unanimously shared) about market economies. In particular, the crisis has made it clear that unfettered markets are not necessarily efficient, stable, or self-correcting. Policies of liberalization and deregulation predicated on those beliefs had contributed to the crisis and its rapid spread around the world. Market failures, including those associated with agency problems and externalities, are pervasive. Social and private costs and benefits are often not well aligned—and these distortions are particularly manifest in financial markets, where not only may there be excessive risk taking, but there may also be distorted incentives, including for innovation. Yet, in some countries and in some quarters, the full implications of the lessons of the crisis had not been taken on board. The crisis was not merely a parenthesis--a brief interlude; the post-crisis world should not resemble the world as it was. Yet there is great pressure to rewrite the story of this crisis by depicting effects as if they were causes—most notably, accusing governments of being guilty for having let the public debt increase. We should not be striving to return to the world as it was before the crisis; we should be striving to create a better balance between markets and the state.

Each country has a responsibility to address these issues in the context of its own economy; but the G20 has the responsibility of addressing these issues when cross-border externalities arise. And in a world of globalization, these have become pervasive.

Macroeconomic Coordination

The strong sense of the group was that 2011 was likely to be weaker, overall, than 2010; that growth in Asia would remain strong, but that China was likely to moderate its growth; that there were significant downside risks for the United States and Europe as formal stimulus packages come to an end—including a risk of continued turmoil in certain financial markets; and that the United States and Europe were not likely to return to anything approaching normal levels of unemployment any time

1. Even today, not all members of the G20 belong to the WTO.

soon (at least as "normal" was used prior to the crisis). It has been underlined that it is the first time since World War II that both side of the Atlantic are characterized by mass unemployment.

Many of the problems that had led up to or contributed to the crisis have so far not be adequately addressed; in some cases, the crisis has itself exacerbated the problems. In the U.S., for instance, bank lending remains constrained, with especially adverse effects on small and medium sized enterprises; mortgage foreclosures are continuing apace, with perhaps 2 million more expected in 2011, in addition to the nearly 7 million that have already gone into foreclosure; housing prices are likely to stagnate—with many predictions of further decreases. Concentration in banking has increased. While there have been some improvements in bank regulations, the group strongly held the view that what had been done so far was inadequate (see discussion below)—neither up to the task of preventing another crisis nor of getting the banks to return to their core mission of sound lending, especially to SME's (rather than gambling, speculating, trading, predatory lending, or exploiting their monopoly position over the payments mechanism). At the onset of the crisis, governments acted properly in taking steps to save the banks, but they did not take stock of the political consequences of doing so in ways that seemingly increased existing inequities. To devote, even potentially, such considerable sums to bail out the financial system--without demanding genuine guarantees that this system would finally return to its public mission of financing the public and private economy--might be justified as a matter of urgency, but it was lacking in foresight. By now the financial lobbies have regained their influence and their capacity to oppose regulations which might have an adverse effect on their profits, even if such regulations would contribute to the well-functioning of the financial system.

Underlying problems that contributed to weak global aggregate demand have also been exacerbated. The UN Commission[2] identified high levels of inequality and high demand for reserves as two critical factors. High unemployment has contributed to weakening labor's bargaining position, even as bonuses have been restored with remarkable rapidity. In some developed countries, governments are taking advantage of this situation to pursue (pre-crisis) programs aimed at increasing flexibility in the labor market and reducing social protection, even though such measures helped

2. Joseph E. Stiglitz and Members of a UN Commission of Experts, *Reforming the International Monetary and Financial Systems in the Wake of the Global Crisis (The Stiglitz Report)*, New York: The New Press, 2010

buffer economies against the worst effects of the crisis. The result is that there is a risk of increasing the already high levels of inequality, at least in some countries.

The marked increase in reserves that began at the end of the last century has also weakened global aggregate demand. Money that countries put aside in reserves is money that they are not spending. Reserve build-up continued, too—encouraged, perhaps, by the fact that those countries with large reserves were in a better position to respond to the crisis.

This discussion of global reserves illustrates the importance of global externalities in the determination of the global macro-economic equilibrium. Actions by one country can have unintended adverse effects on others. Discussions of the Great Depression highlighted these externalities, as beggar-thy-neighbor policies contributed to that downturn. The success (significant, but far from perfect) of the G20 in encouraging resistance to protectionism controlled this form of externality, but externalities remain pervasive: Growth by one country can be of benefit to others. That was one of the arguments for a coordinated Keynesian stimulus. The reverse is also true: austerity in one country has spillovers in others. So too, the failure of one country to regulate adequately its financial sector imposed huge costs on others around the world; the failure to do so in the aftermath of the crisis means that the risks of the imposition of such external costs persists. In a world of globalization, an increase in liquidity in one country can have effects in others—the recipient of the funds need not spend the money in the country creating the liquidity. Indeed, it is even possible that the main effects lie elsewhere. *In the absence of coordination, countries will focus on the domestic effects of policies, without regard to the external effects*. Since global multipliers from fiscal spending are larger than national multipliers, this means, for instance, that fiscal stimuli in a global downturn are likely to be smaller.

It is remarkable that governments which have promoted free trade and globalization seem so often to disregard the consequences of the increased interdependence between their economies.

In these circumstances, the Group felt strongly that it was imperative that governments in Europe and America **maintain strong *sustainable growth policies***—beyond what they might do on their own. Countries like the United States, Germany or France, that can borrow at low interest rates and have high return public investment opportunities (in education, infrastructure, technology, etc) should do so, even if that requires increasing the short-run deficits. Such investments can not only lower

unemployment and increase growth, but also might even lower the medium-term national debt-to-GDP ratio, as GDP is increased and increased tax revenues more than offset increased interest payments. After all, unconventional and innovative measures with attendant risks undertaken to bail out financial institutions avoided the collapse of financial markets. Similar determined exploration of unconventional and innovative measures with attendant risks must be undertaken to revive growth and employment. But even conventional approaches—focusing spending on high return investments—are likely, at least in those countries with access to finance, to lead both to higher growth and lower debt GDP ratios in the medium to long run.

It will be critical to ***recycle savings to areas of high returns****.* There exists a largely misguided formulation of the world's problem as arising from a surplus of savings (say in China) with the concomitant response of encouraging China to consume more. The world needs more investment to address the myriad of problems it faces—including responding to climate change and poverty and adapting to the large structural changes (e.g. urbanization) it is experiencing. The crisis was not caused by an excess of savings, but by the failure of private financial markets to channel savings to areas of high social return. Figuring out how to do this is one of the key challenges facing the G20.

(a) Part of that task involves ***creating institutional arrangements for sharing risk***—so those with the savings don't have to bear the risk, and aren't induced simply to lend to the United States.

(b) Part of the task involves ***creating specialized investment funds***, to create the specialized knowledge and financial instruments for undertaking these investments.

(c) In the arena of investments for climate change, it will be essential ***to create a high price of carbon.***

Sometimes it is argued that issues of climate change or promoting development should be postponed; the focus in Europe and the U.S. (so it is argued) should be on economic recovery. The Group believes that that view is wrong. Investments in these areas can and should be at the center of the recovery. They may even be at the origin of a new wave of technological progress increasing growth potential. ***Economic recovery and addressing climate change are complements***, not substitutes.

In assessing both short- and long-term performance, we have to ***further develop and put into more extensive use better measures of economic performance and social progress,*** measures which take into account, for instance, not only per capita GDP, but also correctly measured household

income and its distribution and sustainability. It is, accordingly, important for the G20 to express its support for the work instigated by the International Commission on the Measurement of Economic Performance and Social Progress. Such measures would show, for instance, that even before the crisis, in some countries which seemed to be showing growth, most citizens were seeing declining or stagnating incomes. Such measures would have revealed, at least in some circumstances, that the growth that was occurring was based on mounting debt, and that there was at least a substantial risk of lack of sustainability.

The Commission, in its work, emphasized too that we needed to develop broader measures of well-being. Employment and decent work as well as economic security are important, not just for the income generated, but also for the sense of dignity and self-respect that it supports.

Recent G20 meetings have focused on global imbalances. It is natural, of course, for some people or countries to borrow, at any one moment, and others to lend. The question is, are there indicators of, say, unsustainable (or unreasonable) imbalances. When oil prices are unusually high, countries putting aside some of their money for a rainy day should be commended for having high savings. While the Group appreciated the difficulty of ascertaining what good indicators are, they felt it would be a mistake not to adequately take into account employment and inequality (e.g. countries facing a temporarily high level of unemployment would be justified in having high fiscal deficits, even if such deficits led to high trade imbalances). Financial markets often look at an excessively narrow set of indicators—and often the wrong indicators. No one would look at a firm and simply comment on its increased indebtedness. The focus is on the balance sheet. But financial markets typically look excessively narrowly at the indebtedness of firms. So too, focusing the attention on the level of fiscal deficits, without taking notice of the level of unemployment or how money is spent misleadingly shifts the emphasis from ultimate objectives to intermediate ones, and gives a misleading account of sustainability.

The G20 should work to create better measures of economic as well as environmental and social sustainability, including *creating frameworks for government and national capital accounts*. While it may be difficult to clearly identify what investments are, the current treatment—which fails to consider any government expenditures as investment--is clearly wrong.

There is a general sense that Central Bank coordination—especially in the immediate aftermath of the crisis—was impressive. Yet, just as the sense of cohesion on fiscal policy has frayed as the crisis has moved into recovery, so too in monetary policy. The strong sense of the Group was that

the US monetary policy of quantitative easing (QE2) was having strong adverse effects on emerging markets which the United States did not seem to fully take into account (consistent with the general theories outlined earlier). Nor was the United States fully taking into account the implications for the evolution of the global financial system. Countries are responding to resist the appreciation of their real exchange rates not only with (sometimes costly) interventions, but also with taxes, controls, etc. These not only obviate some of the hoped-for exchange rate effects of US monetary policy (just as others' tariff policies undid the effects of beggar-thy-neighbor tariff polices); but they lead to a more fragmented global financial market. While for critics of globalization, this fragmentation is welcome, it is ironic that one of the strongest advocates of global financial market integration should be partially responsible for this fragmentation. ***The G20 needs to articulate a clearer vision of how globalization leads to interdependence, increasing the importance of externalities; and while such externalities are universal, they are likely to be particularly significant on the part of large countries, and particularly significant, in the area of monetary policy, on the part of the reserve currency country (or countries.)***

Reforming the Global Monetary and Financial System

The world has faced repeated monetary and financial crises. In the forty years since the world left the Bretton Woods fixed exchange rate system, the international system has evolved in a way that is markedly different from the way that free market advocates like Milton Friedman envisaged. It has been marked by high levels of instability, ever more frequent and severe crises, requiring international bailouts of increasing size. A global reserve system based on the currency of a single country is an anomaly in the increasingly globalized world of the 21st century. Keynes and Triffin anticipated that the system would be rife with problems, and there is a growing consensus that that is the case. While some in the United States see the advantage of seignorage, the ability to borrow at extraordinarily low interest rates—and therefore resist a change—even for the United States, there are marked disadvantages to the current arrangements. Everyone loses from the high levels of instability; but even more, if others increase their holdings of US dollars, it *results* in a trade deficit, and the excess of imports over exports weakens aggregate demand in the United States and contributes negatively to growth. In the past, fiscal deficits (or loose monetary policy) could compensate; in the current situation (and in the foreseeable future) that may be difficult.

The G20 should start a process of a comprehensive re-examination of the global financial system. There are four parts to such a comprehensive re-examination (beyond the coordinated reform of national regulatory systems).

(a) The Reserve System. The current system contributes to lack of global aggregate demand (as countries put aside hundreds of billions of dollars in reserves each year—money which is not spent) and is unstable and inequitable, with poor countries lending trillions of dollars to the reserve currency countries, at low (now close to zero) interest rates. A global reserve system can partially ameliorate these problems. As the UN Commission emphasized, there are many variants of such a system—more ambitious versions can be used to promote stability and address problems of global public goods, less ambitious versions can simply address the deficiencies in current arrangements. There are also a variety of institutional arrangements and various ways that the transition from the current system to the new system can be managed.

Among the variants discussed by the UN Commission there is one in particular that may be of especial relevance to the G20 discussion. It is conceivable that the current reserve currency country may not see that it is in its interests to move toward a global system; it may wish to continue what it sees as its privileged position, and will accordingly put roadblocks to the creation of an alternative. ***The G20 cannot let any country obstruct the creation of an alternative system. There are alternatives in which a group of countries works together to create a reserve system.*** Indeed, such arrangements already exist. One approach is to extend and strengthen these arrangements.

The Group felt strongly that The ***G20 should create a process of examining these alternatives, with the intent of instigating reforms in the reserve system as soon as possible.*** Reforms can be sequential, with successes at one stage contributing to further reforms. Thus, building on the successes in the expansion of SDR's in the London G20 meeting, ***The G20 should commit itself in the interim to regular SDR emissions.*** The effectiveness of these SDR emissions would be increased if certain constraints on their use (e.g. for IMF lending) were eliminated, and if those without need for more reserves (e.g. countries with large reserves and persistent surpluses) could and would transfer their allocations to, say, developing countries.

The global reserve system is likely to change. It has already moved from a dollar to a dollar-euro system. It may move to a three or four reserve currency system. Such a system, however, would not solve any of the problems noted earlier; it may (and in the view of many of the members of the group is likely to) be even more unstable, with increasing volatility of exchange rates. The problems of insufficiency of aggregate demand and inequities would persist, and the problem that monetary policy authorities of reserve currency countries pay insufficient attention to the consequences of their actions could be exacerbated. In short, unless the G20 address this issue frontally, there is a significant risk that the world will move to an even more dysfunctional system.

(b) Exchange rate determination. The vision that many had the Bretton Woods system came to an end was that farsighted markets would lead to stable exchange rates, which would adjust gradually and efficiently as economic circumstances changed. That was, of course, before the days of massive short-term capital flows and high levels of speculative activity using new financial instruments. Similarly, before the Argentinean crisis, many argued for the bipolar view: countries should either have fixed or freely flexible exchange rate (the two systems have in common a belief that there should be no discretionary government intervention). Today, most countries recognize that there are at least times where they should intervene, and that exchange rates are affected by a host of government policies, from interest rates, to financial market regulations, to government bank guarantees, etc. Whether such policies are adopted with the intent of affecting the exchange rate is not the question; countries often deny that they do so. The fact is that change in the exchange rate is one of the important (general equilibrium) effects, and indeed, in the case of monetary policy, one of the main channels through which effects of various policies is felt. Thus, the ***G20 should put to rest the shibboleth that the solution to international economic problems entails allowing free market determined exchange rates.*** As we noted earlier, one of the main lessons of the crisis is that market prices may neither be efficient nor stable.

(c) Management of cross-border capital flows. Another lesson of the crisis is that unfettered financial markets are neither efficient nor stable. There needs to be financial sector regulation. But, remarkably, the question of regulation of cross border capital flows has been largely omitted from the discussion. In response to large

exchange rate appreciations resulting from surges of capital flows (some related to monetary policy in reserve countries), already countries are engaged in a variety of interventions to prevent distortionary and costly currency appreciations. Experience in prior crises (such as that in East Asia at the end of the previous century) showed that short term capital flows could be very destabilizing and help precipitate a crisis. Research has corroborated that these short term flows do not necessarily enhance growth and may in fact have adverse effects on growth as well as stability, and are not necessary to bring about long term investments. *In spite of this research and the lessons of the crisis, many international and bilateral agreements impose restrictions on countries' ability to adopt regulations that enhance capital account management.* ***The G20 should expressly acknowledge the importance of capital account management, especially in periods of economic stress, and should initiate a process of review of all international agreements to ascertain when such agreements interfere with countries' ability to engage in capital account management.***

(d) Sovereign Debt Restructuring Mechanism. Previous sovereign debt restructurings have, in many cases, been disorderly, imposing excessive costs. ***The G20 should initiate a process for designing a sovereign debt restructuring mechanism.*** While the IMF may have an important voice in these deliberations, it should be recognized that as a major creditor, and as an institution controlled by creditor countries, it cannot be at the center. The process must have equal representation from debtor and creditor groups.

Climate Change

As noted earlier, the Group strongly believed that actions addressing climate change could and should be part of the strategy for economic recovery. In addition to the concrete actions described earlier, creating a risk facility to support the recycling of surpluses from surplus and reserve countries to finance climate change in developing countries, other ***mechanisms of innovative finance*** should be pursued (see below under development).

In addition, ***the G20 should continue articulating the imperative of responding to the challenge of climate change, particularly by noting the quantitative implications in terms of emissions per capita of commitments made earlier concerning limiting global warming to 2 degrees centigrade.***

Previous international agreements have provided a number of commitments concerning climate change, including those concerning the use of compulsory licenses for the transfer of technology and actions related to terrestrial carbon (REDD), but in some cases, impediments have arisen to their full and effective implementation. The G20 has an oversight role in global governance, and in that role, ***the G20 should establish a process to identify and rectify impediments to the full implementation of existing agreements.***

Knowledge is a public good, and the development of technology to increase carbon efficiency is, in that sense, a double public good. There will be underinvestment in climate change research by the private sector, especially in the current context where carbon is vastly underpriced. ***The G20 should establish a process for creating a global research fund for climate change***.

It makes sense that the richest countries and the largest polluters contribute most to the funds, but once technologies for reducing carbon emissions are discovered, it is in the world's interest that these technologies receive the most widespread use. That means that newly developed technologies should be made freely available to developing countries, and perhaps to all countries that have contributed to the fund.

Meanwhile, some countries are using trade policy to impede other countries taking more effective actions, asserting that industrial policies to promote green technologies are an unfair trade action. ***The G20 should acknowledge the superiority of collective research efforts-- with extensive dissemination of the fruits of that research through low or zero royalties. It should also hold that until a fully effective international consortium is established, countries should be encouraged to promote the development of green technologies, whether through government sponsored research or industrial policies, so long as the country agrees to comply with provisions of earlier agreements on compulsory licensing for developing countries.***

Financial Sector Reform

The consensus among the Group was that there were important deficiencies in actions taken thus far to curb the kind of behavior of the financial sector that contributed to the crisis, and other aspects of the behavior of the financial sector which undermine its ability to fulfill the economic roles that it should play in our societies. The Group urged the G20 to take on board several issues that so far have been given short shrift.

Systemically significant financial institutions (at least those that are not subject to intensive and close supervision, of the kind not evidenced prior to the crisis) present a systemic risk to the global financial system and the global economy, because of their incentives for excessive risk taking. Such institutions are also effectively subsidized, as a result of their access to funds at lower interest rates, creating a dysfunction dynamic, in which they grow ever larger. While resolution authority was desirable, it is clearly not *the* solution, especially in the case of financial institutions that operate across borders. So to, additional capital provisions are necessary, but not sufficient to address the gamut of problems that have been identified. There needs to be tighter regulation and more intense supervision in a number of dimensions, both nationally and globally.

1. The question is not just whether governments have resolution authority, but whether in the midst of a crisis governments are likely to use the authority that they have to force bondholders and shareholders to bear full losses; the persistence of differential interest rates suggests that the market believes that they will not.

2. The Group emphasized, however, that while there has been inadequate attention paid to too big to fail banks, it is not the only problem. Large numbers of institutions undertaking correlated behavior can pose a systemic risk to the global economy, even if all of them are small.

3. Several of the key problems posed by CDS's and other derivatives have not been adequately addressed. This includes: (a) whether they are viewed as insurance products or gambling instruments, it makes no sense for them to be underwritten by governments, as they are when they are written by government insured banks. (b) Only a portion of them have become transparent, as they move to clearing houses. (c) But moving to clearing houses will not resolve ongoing concerns unless they are adequately capitalized and they and their governance are transparent.

4. Basel 3 (referred to as Basel 2 Plus) doesn't adequately address the problems that the crisis brought out. There was no convincing evidence that, had it been in place, the current crisis would have been avoided. There appears to be continued reliance on rating agencies and self-assessment of risk. Moreover, the long time allowed before full implementation means that even if it were adequate, the global system will be exposed to continuing risk in coming years, possibly even more so as banks may attempt to undertake even more risk in the periods before full implementation.

5. Most countries have not adequately addressed the problems posed by incentive structures in the financial sector, especially as they lead to excessive risk taking. Given the obvious role that such incentive structures may have played in creating the crisis, which has had such devastating effects on so many citizens, the failure to do so is having an enervating effect on many democracies, as they come to believe that political processes are dominated by financial interests. Taxpayers in many, if not most, of the countries engaged in massive bailouts have the impression that the banks got an unfairly good deal, and they were handed a bad one: the banks could continue to pay out (in the US) dividends and bonuses—on which they often pay unfairly low taxes; the increased concentration in the sector enhanced profits—forcing borrowing to pay much higher interest rates than the rates at which the banks could borrow (the spread increased). That meant that the benefits of record low levels of T-bill rates didn't trickle down to the real sector—those who have to create the new jobs to get the economy going. Banks' political investments paid off once again more than their economic investments, and their political power bounced back faster than their balance sheets returned to health. Those in finance are putting increasing pressure on governments not only not to regulate, but to cut public spending.

6. The financial systems' monopoly on the electronic means of payment has been widely abused, effectively imposing a tax on most transactions between consumers and producers, the revenues of which do not, however, go to public purpose but enrich the financial sector. Some countries have shown that curtailing these abuses can be relatively easy. ***The G20 should curb these monopoly practices and consider substituting in part the monopoly tax with a tax to be used for climate change and development.***

7. The G20, in earlier meetings, focused on how cross border capital flows undermined the tax system. But it has also facilitated corruption, with money flowing from poor countries to accounts protected by secrecy, in both off shore and on shore financial centers. There needs to be a commitment not only to more transparency, but to repatriation of such funds when they are identified. The Group reiterated the concerns expressed by the UN Commission, and subsequently bolstered by others, that work of the G20 on uncooperative jurisdictions was not as transparent, balanced, or comprehensive as it might have been. It is not just

offshore countries that are the problem; several of the largest financial centers have been identified as posing problems.

The G20 needs to be sensitive, as it goes about the task of overseeing reforms of the global financial system that assert the importance of transparency--especially given the large role played in the G20 by the countries with the largest financial centers, which were responsible for the global financial crisis itself.

The Development Agenda

The Group welcomed the initiatives of the G20 at Seoul, and most believed that it should continue to push forward on a Development Agenda. One member, perhaps reflecting sentiments of many in the developing world, questioned the legitimacy of the G20's efforts in this area, given the lack of representation of less developed countries and given the failure of the representatives of the advanced industrial countries to live up to their commitments on aid.

The G20 made laudable efforts to ensure funds were provided to help developing countries respond to the crisis, especially in the London 2009 meeting. The quick recovery of the emerging markets and the impact that that has had on commodity prices has meant that the severity of the crisis in most developing countries was not as bad as was feared. Yet the crisis made clear the limited coping capacity of the developing countries, the inadequacies of current resources, and the risks of depending on private markets for investments, even in areas like infrastructure, where they have at times played an important role.

The Group strongly urged that the ***G20 should continue its work on innovative finance, and even if there cannot be agreement among all countries, efforts should be undertaken (along the lines of some that have already been undertaken) to ensure that some measures be adopted—coordinated by groups of countries—as soon as possible. The Group was particularly supportive of a financial transactions tax, which now seems to have mustered large support from the citizens of a large number of countries, and versions of which have already been adopted by some countries.***

Research in recent years has identified a number of versions of taxes on the financial sector that could both raise considerable amounts of revenue and increase economic efficiency, undoing some of the distortions currently associated with the financial sector.

The economic principle is clear: it is better to tax bad things (like pollution) than good things (like work and savings); there are large social costs associated with speculative activities; and a small financial transactions tax would effectively differentiate between short term speculation (where it could represent a large fraction of the returns), and long term investments, where the tax would have a negligible effect. The tax could raise substantial amounts of money.

Another innovative source of finance could be the issuance of SDR's, as recently discussed in the IMF.

One source of particular concern is lack of funding for social protection. ***The G20 should consider funding a contingency fund for developing countries that put in place appropriately designed social protection systems.***

Another source of concern is more permanent funding of infrastructure and trade finance. As noted, private sector funding cannot be relied upon. It can disappear just when it is most needed, putting developing countries in a most vulnerable place.

Funding is necessary but not sufficient for development. Trade policy is important too. Since the beginning of the Doha round nearly a decade ago, much of the Development Agenda has been weakened. It is, for instance, important that the developed countries open themselves up unilaterally to the least developed countries and that there be binding commitments for aid-for-trade, so that developing countries can avail themselves of the opportunities afforded by trade liberalization.

With so many new players in the provision of development assistance, coordination will become increasingly difficult, but important. The G20 should work to ensure the effective use of funds provided.

In the era of budget stringency in which the advanced industrial countries seems to be moving, it is imperative that aid budgets not only be maintained, but increased, as countries work to fulfill their commitments to provide .7% of GDP. ***The G20 should renew its commitment to provide. 7% of GDP for assistance to the poorest countries,*** and it will be particularly important to guard against the risk of diverting increasing amounts of funds to political agendas only tangentially related to helping the poorest countries (e.g. to the war in Afghanistan.).

Many of the most troublesome countries are those with failed states. Donors are often hesitant to provide assistance to such countries, lest they appear to be supporting the corrupt dictators at the top. But not to provide assistance to such countries condemns the citizens of those countries to

suffer doubly: to the misfortune of poor governance is added the absence of education and health and other public services normally funded partially or totally with such assistance. This will make the opposition, when it comes into power, less effective, and may even impede the process of transition itself. Donors need to find delivery mechanisms for providing assistance directly to people—when states allow it, as many do--in ways that enhance civil society and individual capacities.

Reforming Global Governance

The G20 was an important step forward, in comparison to the G8. Most of the important global issues could not be addressed without participation of at least the emerging markets. If the G20 proves effective, many of the concerns with the G20 may become more muted. Among these are that, even though around three-quarters of global GDP and more than 60 per cent of the world population are represented, 172 countries are not members, and there is a certain capriciousness concerning the membership; it lacks representativeness and political legitimacy. There is only one African country—South Africa. There is also concern of the impact of the G20 on other international organizations, when it appears that a group (albeit with a large fraction of the voting shares) makes decisions that it can effectively impose on the entire organization. At the same time, in certain critical areas, like climate change, where it might be hoped that intense discussions among a small group might be able to craft a global deal, the G20 has failed to do so.

The Group supported a two-pronged approach. ***The G20 should openly recognize the limitations on legitimacy and representation and the potential problems posed to the governance of other international institutions, and set up a process to address these issues. At the same time, it should work to bring itself more formally within the framework of the United Nations System.*** On representation, for instance, the example of the Security Council might be followed, with permanent representation by the largest economies, combined with regional representation on an elected but rotating basis. The G20 might see itself evolve toward the Global Economic Coordinating Council called for by the UN Commission. The UN Commission articulated some of the considerations that ought to be borne in mind in the design of the GECC, including size, diversity, continuity, and legitimacy.

But the Group recognized that these reforms might take considerable time. In the meantime, the Group suggested three more immediate measures.

Attempts to ensure that the voices of Africa and labor are heard--by inviting representatives from the AU and ILO—are welcome, but there was concern that they be actively involved in the deliberative processes on a permanent basis. ***The G20 should invite the AU to have a representative on the G20 on par with the other members, and that the ILO should be given the same status as the IMF.***

The Group supported the recommendation of the UN Commission for the ***creation of a scientific advisory council to the G20, which might help set the agenda, identify problems in the system of global economic, social, and political governance, and lay out alternative approaches to their resolution.***

Repeatedly, as the G20 set about its tasks, it has had to call upon the OECD for advise, e.g. on uncooperative jurisdictions. While the move from G20 to G8 has brought on board voices from the emerging markets (but not the least-developed countries), it seems an anomaly that when technical advice is sought, there is such reliance on an organization of the advanced industrial countries (and even the IMF is an organization that, at least in formal governance, is dominated by the advanced industrial countries). ***The G20 should set in motion a process for the creation of an organization which will perform for emerging markets and the least-developed countries the same task OECD is performing for the industrialized countries.*** It would be designed to work closely with the OECD on problems of global significance, for example by jointly setting up a ***World Global Governance Institute.***

Many of the initiatives the G20 has undertaken in recent years have involved "variable geometry": bringing to the table various parties whose interests center around the particular issue under discussion. This was true, for instance, in the formulation of the Development Agenda. As the G20 agenda gets extended, maintaining and extending these practices will be of increasing importance. It will also be important to maintain transparency in the processes, if they are to maintain legitimacy.

Many of the policy and governance reforms and initiatives discussed in this note can be more easily conducted at the regional level. The G20 should encourage the evolution of regional arrangements, so long as they are not designed to—and do not have the effect of—undermining the multilateral system.

The agenda the Group discussed, while comprehensive, was far from exhaustive. Many issues have been left aside. In particular, the important issue of commodity price stabilization—which in the light of current evolution is becoming of real concern--has not been dealt with.

Commodity price fluctuations are in effect particularly destabilizing, especially those of agricultural goods, because of their consequences on food prices. Recent events in many developing countries are teaching us the gravity of their social consequences. Can we devise methods to help stabilize these prices, or is such an objective out of reach? Nor have we addressed the issue of the needed reform of existing international institutions, for example. We leave that and other issues to future work, hoping that during the year the Paris Group will come forward with further recommendations.

PART II

PREPARATORY NOTES

The notes presented here have served as background materials for the discussion during the first meeting of the Paris Group. Most of them are dealing with several of the issues we proposed for discussion, including cross-cutting issues. They are thus not arranged according to the structure of the chairmen's summary. They represent a collection of short papers dealing with some of the most important problems of our time. They thus help to get an insight into the major issues of the G20 agenda.

1. GROWTH AND DEVELOPMENT

A NEW GLOBAL GROWTH COMPACT

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INTERNATIONAL DEVELOPMENT

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A NEW GLOBAL GROWTH COMPACT

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The G20 enjoyed a moment of enormous success in the response to the global economic crisis in late 2008 and early 2009. Cooperative actions to undertake strong stimulus and to avoid protectionist measures helped avert turning the crisis into another Great Depression. Since then, though, the sense of cohesion seems to have evaporated, leading some to question even the relevance of the G20. This note attempts to explain the momentary success and the subsequent failures. It suggests an alternative framework for discussions, and then to apply that framework to the central problem facing the world today, how to prevent a growing global divide with the associated tensions, with Europe and the United States sliding into a long term malaise, while Asia enjoys robust growth.

The underlying problems

The early successes of the G20 were based on a shared vision and shared interest: the entire world faced the common threat of recession/depression, and there was a common understanding that the only way to combat the downturn was strong government action, both to save the banks and to stimulate the economy. There is little evidence that any country reshaped its actions significantly in response to the G20, but the meetings reinforced leaders' convictions of the need to take strong actions and commitments not to undertake protectionism.

Since then, though, marked divisions in circumstances and perceptions have arisen. The moment when there was a consensus that "we are all Keynesians" quickly passed, aided and abetted by the looming deficits (caused largely by the economic downturns.) Whether leaders espouse the

view that deficit reduction will restore confidence and that will restore growth really believe these ideas (for which there is virtually no empirical support), or they are simply reflecting the beliefs of voters and particular interest groups, it is hard to develop concerted policies when (a) circumstances differ so markedly, with some countries facing inflationary pressures, others facing the prospects of unacceptably high unemployment; and (b) perceptions differ so markedly, with some countries believing that the best way to recover is to cut spending, others believing the best way is to increase spending.

There is another problem, and that is the way countries interacted before the crisis to reach an agreement—and especially the way developed countries interacted with emerging markets. Countries lectured each other too much. The United States, as the putatively most successful country, would lecture others about how they should reform their economies if they were to have strong growth. The United States was the teacher, the emerging market the student. The United States would describe the reforms as helping the emerging market country—as being in that country's best interest. And according to the American lecture, it was coincidental that the reforms were also advantageous to the United States and other industrial countries. If growth was enhanced, the argument went, everyone benefitted

To the extent that there was a negotiation, it was unbalanced. This was evident in the Grand Bargain that underlay the Uruguay Round negotiations, where the developing countries fulfilled their part of the deal, but the advanced industrial countries still have not upheld their end (the reduction in agricultural subsidies).

When the lectures alone didn't work, threats were invoked—the imposition of tariffs, the withdrawal of some benefit. Those in emerging markets were never sure about whether the threats would be carried out or the magnitude of the effects if they were; but political leaders typically didn't want to bear the risk, especially given the widespread belief that coups could be engineered, opposition parties could receive financial support, etc. Agreements were reached, but not on the basis of trust and equality.

The crisis exposed weaknesses in the institutional frameworks in some of the advanced industrial countries and undermined the credibility of their economic advice. As a result, this mode of interaction between industrial countries and emerging markets simply won't work any longer. Moreover, with the growth of trade agreements, the scope for trade sanctions has been

diminished. With the growth of democracies, threats can backfire: electorates may demand that their governments not appear to be giving into outside pressure. It was a system that was often resented before the crisis, and was growing increasingly ineffective. But today, this mode of interaction has to be discarded, added to the dustbin of history.

All negotiations are based on give-and-take, attempting to find areas of agreement and concessions—concessions in which the sacrifices of the conceding party are of less value than the gains to the other parties.

There is one more explanation of the difficulties encountered by the G20, and that is institutional. The G20 is supposed to provide a framework where leaders can come together and exchange views, helping to overcome bureaucratic impediments. There are two difficulties with this "vision" of the G20 process. The first is that, in fact, most of the work leading up to G20 meetings is conducted through its own "bureaucratic" process, which, depending on the country, may be more or less connected with the governmental structures that will be relied upon to implement it. Secondly, in some countries, leaders may feel uncomfortable with making any commitment that has not passed through appropriate channels. The result of these two difficulties is that in practice there is little room for real substantive and spontaneous give-and-take in the leaders' meeting.

An alternative would be for the leaders to focus on medium to longer term "vision" issues, with the bureaucratic processes being charged with developing concrete initiatives to translate these visions into practice.

As an example, the leaders might discuss the risks of excessively consumption-oriented societies, and the role that new measures of economic performance and social progress might play in assessing performance and redirecting resources. The leaders might provide impetus not only to this kind of initiative, but draw attention to particular issues—such as inequality or insecurity or employment—that could be the focus of programmatic work going forward.

As another example of the difference between the old and the new frameworks, take the adjustment of China's exchange rate. Discussions often begin by explaining to China that having an undervalued exchange rate is against Chinese interests. But China believes that it knows its own economic situation better than American officials. China consults widely with economists in and outside of China, and knows that many American economists have markedly different views than those of U.S. officials. China has, for instance, instruments for controlling inflation that may not be available in advanced industrial countries. (The irony that American officials repeatedly lectured China on the problems in its banking

system—when it was the U.S. banking system's problems that was responsible for the global crisis—has been well-noted.) Now, China's economists explain how a too-rapid appreciation of the currency will lead to high unemployment in China and economic instability—a result that, they explain, will be in neither China's interests nor those of the global economy.

What matters is the adjustment of the *real* exchange rate, and that can be accomplished either by an adjustment of the nominal exchange rate or an adjustment of internal prices, e.g. through increases in domestic wages. The latter has more subtlety, allowing smaller increases in wages where those adjustments would avoid the large employment impacts of large adjustments in nominal wages. (Of course, in the presence of perfect flexibility of wages and prices and perfect and complete contracting, there is no difference between the two—and no reason that the United States couldn't make its own adjustment through decreases in domestic wages and prices. These "imperfections" explain both why the US does not want to impose deflation on itself, and also why China might not want to confront all of its firms with an increase in the nominal exchange rate.)

When China fails to be convinced that increasing the exchange rate is in its interest, the United States resorts to threats. Congress threatens to impose a tariff. The United States (and others) attempt to use arguments of equity: it is unfair to others for China to manipulate its exchange rate. But fairness, like beauty, lies in the eyes of the beholder. In response, it is pointed out: (a) low interest rates (quantitative easing) impose costs on others and "artificially" depresses the U.S. exchange rate; and (b) high agricultural subsidies hurt China's poor farmers, and a low exchange rate is a way of partially countervailing these subsidies. Other methods (such as China providing countervailing subsidies to its farmers) would take away scarce money that could be used to promote education, health, development and other social objectives. Within much of the developing world, these arguments have some resonance.

There is a way out of this impasse, and that is for the G20 to adopt a global growth compact. This is a framework which represents a Pareto improvement for all countries, enforced by much self-interest, and which reflects each country's sensibilities about their own economy and "fairness."

Symmetry is of the essence in this global growth compact, both for macroeconomic policies in the short run, and for structural policies in the long run. In a context of global demand deficiency, asking for adjustments only from countries facing a problem (whether of debt or of balance of payment, or both) is a recipe for deepening the deficiency. In a context

where most (rich) countries are subsidizing their agriculture, it will not help the world economy to lecture emerging and developing economies on the benefits of free trade. Symmetry implies, too, that a national currency can't be any more than the international reserve currency. In an environment of persistently high unemployment, it would not help the recovery of the world economy for deficit countries to raise their taxes, say, on labor. If taxes are to be raised, a carbon tax—all the better if it is global—is a much better option. To sum up, symmetry would serve both equity and efficiency.

Hence, the key ingredients to this sustainable global growth compact are the following:

— All countries with the fiscal and economic space to undertake expansionary policies do so. Otherwise there will be a (structural) restrictive bias in global macroeconomic policies, as only those countries considered as having an unsustainable public finance situation would be required to adjust. And it can't adjust but downward.

As growth occurs, countries with trade surpluses take actions to reduce those trade imbalances, in ways that they believe are consistent with their short- and long-term objectives. This will normally entail exchange rate realignments. But it would be mutually recognized that sometimes so-called market-determined exchange rates may not be appropriate (e.g. when markets are distorted by speculative capital flows) and that governments may need to intervene. (With growth, adjustments in exchange rate would be easier, because the threat of large scale bankruptcies would be reduced, and the consequences of any bankruptcy would be lower, since there would be new job opportunities.)

Countries with surpluses would commit themselves to recycling those surpluses to areas where the global social returns are high. For example, they could fund green investments to help, say, developing and emerging markets to retrofit themselves to address the challenge of global warming. The international community would set up such funds, so that the risks would be globally shared.

As countries with surpluses restructure their economies to reduce those surpluses, they would recognize that restructuring cannot be based on environmentally or economically unsustainable consumption: it must be based on long-term investment and consumption patterns that are sensitive to emission consequences.

The global community would commit itself to closing the gap between rich and poor countries, which entails provisions for "helping infant

economies grow," e.g. allowing them greater latitude in industrial policies. This would reduce the need to use exchange rate policy as an instrument for promoting exports. The international community would similarly commit itself to a developmentally oriented trade and intellectual property regime. This would entail the phasing out of agricultural subsidies. In the meanwhile, a "concession"—of some value to the developing country, of relatively little cost to the developed countries—would allow developing countries to impose countervailing duties against subsidized agricultural imports.

By the same token, it makes little sense for advanced industrial countries with aging populations to be running large trade deficits, but how they correct those trade deficits matters. If they raise taxes on labor or savings to reduce their fiscal deficits, that might reduce their trade deficit, but at the expense of growth.

On the other hand, a global carbon tax would help promote sustainability, and lower taxes on workers could simultaneously promote growth and equity, and increase aggregate demand.

A new global reserve system would help increase global aggregate demand, and if appropriately designed, increase global equity.

Such a growth compact (there are many more details that can be filled in) can simultaneously promote growth, equity, and sustainability. All countries would benefit, though some special interests (in each of the countries) might suffer.

This example illustrates the more general theme: it is a global agreement where no country is lecturing another about what it should do. Some previous lectures proved to be wrong, and there is a growing sentiment that symmetry, besides being fairer, and more likely the basis of a global agreement, would be more growth enhancing. In each country, some special interests will be hurt, but the country as a whole benefits. No country should take the stance that its special interests have priority over the special interests in others. (Some countries take the stance that because of their political processes, particular special interests have the ability to block any agreement. According to this logic, political realism entails simply accepting this "political constraint," and working around it.)

Conventional wisdom holds that making reforms is painful, but in the long run, the benefits are worth the pain. A better way of putting it is that there are certain groups within countries that will resist these changes, but with many of the reforms described here, the country as a whole is actually better off, even in the short run.

INTERNATIONAL DEVELOPMENT

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The G20 Seoul Summit Document had at its heart: international macro and financial reforms; IFI reform; fighting protectionism and promoting trade and investment; and the Seoul Development Consensus for Shared Growth/Multi-Year Action Plan (MAP) on Development. This combination reflects strongly the vital transition from a G7/G8 club of rich countries to a G20 group representing the major economies, populations and driving forces of the world economy and politics. The Development Consensus/MAP were real achievements, substantial steps forward and very welcome in their priorities and specificities. Thus central to the challenge for the G20 in 2011 is implementation. There was much said in Seoul about 'commitment' and 'accountability', we will see how serious that was in 2011.

At the centre of the Development Consensus and MAP were infrastructure, skills and banking/financial systems. All these are basic to the investment climate which drives private investment, the engine of growth, be it on the family farm or in the big firm. They are also basic to the ability of people to participate in the economy and society so that growth is shared within and across countries. The investment climate and the ability to participate depend also, and crucially, on a range of policies and institutions within the country, but infrastructure, skills and banking are areas where those outside poor countries can play a particularly helpful role.

Above all the story of Seoul, and rightly so, was growth and the participation in growth. It is these two together that have driven past successes in overcoming poverty and will do so in the future, particularly in low-income countries (LIC), or the poorest countries in the world. Their progress will be linked inextricably with the conditions for investment, the funding for investment, the investment in people, and the open-ness of the international trading system. The G20 must maintain its emphasis on these issues and follow the MAP.

The growth/infrastructure/skills story is not a diversion from poverty reduction and food security. On the contrary it is in large measure the most important factor in achieving results on these two crucial objectives.

At the same time it must be clear that growth and the overcoming of poverty are interwoven with the management of climate change. Low-carbon technologies and the transition to low-carbon growth are at the centre of the growth story around the world in the next few decades. Access to power for so many of the 1.5 billion now without it, is likely to be focussed on renewables. And it is the developing world which is hit earliest and hardest by unmanaged climate change. Further, we must recognise (see accompanying paper on climate change), that it will be impossible to bring emissions down to the necessary 2 tonnes per capita (carbon-dioxide equivalent) in 2050 for the then 9 billion people in the world, unless the 8 billion in the (currently) developing world in 2050 are below 2½ tonnes per capita (and that would imply zero emissions in 2050 for the currently rich countries). Overcoming poverty and managing climate change are inextricably linked both in the consequences of inaction and in the required elements for effective action. The emerging and poor countries of the developing world will be laying down the infrastructure in the next two decades which will determine whether we succeed or fail on these two together. Thus as we boost infrastructure we should ensure that we also, as a world, embrace the new energy-industrial revolution.

Infrastructure must be a special priority in the development process in both the rural and urban sectors. Both sectors are essential in overcoming poverty, but urban infrastructure will be a special challenge given the very rapid pace of urbanisation. Infrastructure investment was understandably top of the list in the Seoul Consensus/MAP priorities together with investment in skills.

In this context the establishment and empowerment of the G20 High-Level Panel for Infrastructure Investment is an urgent priority. It will be a key vehicle for articulating priorities, providing and promoting analysis, and creating momentum for country policy, the private sector and the IFIs. The December deadline for appointing the chair seems already to have been missed.

Of course, panels alone do not create investment, and country-level policy for the investment climate will be key, but the Seoul Consensus, with its strong emphasis on growth, does indicate a shift in international development policy in a sensible direction. As the investment climate improves, the challenge of funding investment will become ever stronger. The financial system will be crucial because funding from the public

finances and the IFIs will fall far short of what is necessary. This means looking at international financial sector reform in part through the prism of whether it can yield the necessary financial flows to finance the large required infrastructure and low-carbon investments. This should include asking how flows of some parts of the large surplus in some countries of the world, including China, could usefully and profitably be used to finance a significant part of this infrastructure investment in the poorest countries.

One final point on the reform of the international financial institutions, the deepening and maturing of their commitment to development, and their adjustment to the new G20 rather than G8 world: the headship of the IMF and the World Bank. The G20 has indicated in earlier summits that the old and unjustifiable deal or convention, under which the head of the IMF goes to Europe and that of the World Bank to the USA, is no longer tenable. Trust in the commitment of rich countries to development and the new order would be gravely damaged if, as a result of an allegedly open competition, the same IMF-Europe and World Bank–USA outcome were to arise. The challenge might come in 2011. Europe and the USA must state clearly not only that the competition will be open, but also, given the past history, that there should be a special focus on qualified individuals from outside Europe and the USA.

2. MACROECONOMIC AND STABILITY ISSUES

FISCAL POLICY FOR RECESSION

Kenneth J. ARROW – *Stanford University*

POLICY COOPERATION FOR THE G20
BEYOND GLOBAL IMBALANCES

Kemal DERVIS – *PNUD*

A NEW CHALLENGE FOR EUROPE

Andrei BOUGROV – *Interros Company*

FISCAL POLICY FOR RECESSION

Kenneth J. Arrow
Stanford University

I make two suggestions for the agenda of the G20 meeting. The first is, I am pretty sure, quite unattainable at the moment but should be an item in the discussion.

Fiscal Policy Recession

Despite all the political rhetoric in both Europe and the United States, the simple idea that increased government spending can offset unemployment seems to me hardly deniable. Government spending may have other adverse consequences: (1) it increases the public debt which may or may not have long-run negative consequences, depending on future developments, and (2) because of the lag between spending decisions and actual spending, the spending may not come until it is no longer necessary. Given the depth and probable length of the present recession in Europe and the United States, the latter reason is probably not operative. I note that Milton Friedman never denied the job-creating effects of government spending; his objection to it was basically point (2), that the government was a poor predictor (in his view, a poor economic performer in any dimension).

This is of relevance to the G20 through its international dimension. The effect of an expansionary policy in any one country is diminished by leakage. Hence, there is a value to coordination of fiscal policy to avoid, "beggar-my-neighbor" effects. Macroeconomists have been preoccupied with this subject for upwards of forty years, with little effect. Even the Euro zone cannot achieve coordinated fiscal policy. I suppose this bastion of sovereignty will not be breached soon, but it would be good to have the question of internationally coordinated stimulative policy at least an item in the agenda for discussion.

Openess in financial information

No doubt the argument about the causes of the recent financial collapse will never be fully ended. We still have widely divergent analyses of the Great Depression, now eighty years in the past. One aspect is certainly the question of information and belief. Who knows what? Economic theory for the last fifty years has been studying the concept of asymmetric information. If there is one thing that is clear, it is that individual players in the economic game have access to differing bodies of information. They form beliefs on what they know and, presumably, on what they can infer from the actions of others. (E.g., if securities prices are going up, though I know nothing which would explain why, I might infer that someone else has some favorable knowledge, and therefore revise my beliefs.) A further point is that information is, after all, a commodity, in the sense that it has value and it has cost, but it does not have the usual properties which make it suitable for marketability: It can be transferred to someone else without giving it up, it is not easily appropriable, and a given amount of information can be used in any scale (for purchases of securities or for production). On the other hand, much information is transferred by social interactions without any necessary monetary counterpart.

Putting all these considerations together, there is strong reason to make as much financial information available to all as is practicable. Thus, if financial institutions finance lending by short-term (frequently 24-hour) borrowing, that fact should be revealed with high frequency so that all may judge of the firm's creditworthiness. It also implies that derivative securities, such as credit default swaps, should be traded on well-organized markets, with the usual guarantees for performance (as in futures or stock markets) and prices that are publicly known. If these prices do convey information about the probabilities of default of a security or a firm, this information will be publicly known and can be acted on by both private investors and government regulators.

Whatever the full set of causes of the Great Recession are, it is clear that the initial difficulties were greatly multiplied by the degree of leverage in investment banks and hedge funds. A minimum step is to reveal to everyone the amount of leverage, and this requires the increased scope of compulsory reporting and of the use of publicly regulated organized markets for risk-bearing.

POLICY COOPERATION AND THE G20
BEYOND GLOBAL IMBALANCES

Kemal DERVIS
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(The Focus of this Note is on the "Indicators" that the "Framework Working Group" with input from the IMF and other institutions has to propose to the G20, to help agreement on global "rebalancing", as decided at the Seoul meeting).

The G20 MAP (Mutual Assessment Process) is grounded in the justified belief that cooperative economic policies can achieve a better outcome for the world economy as a whole, as well as for the individual G20 countries, than economic policies that are designed and implemented in isolation, without regard for spillover effects and without taking into account the interdependence between economies.

The "cooperative scenario", as described by the IMF, including in various speeches by the Managing Director, involves demand expansion in the surplus emerging market economies, notably China, and in some other surplus countries such as Germany, compensating the growth dampening effects of fiscal consolidation needed in many advanced economies. Fiscal consolidation is believed to be required because of debt dynamics that could provoke an increase in interest rates and negative expectations, notably in the US. The inevitable short term negative effect on demand would be compensated for by increased demand for exports coming form surplus emerging market economies. Moreover, the needed fiscal consolidation in advanced economies would be gradual and differentiated according to fiscal space in different countries: Germany would reduce its budget deficit by a much smaller amount than the UK or the US, for example. The October IMF WEO contains some careful empirical analysis on the effects of fiscal consolidation, showing that generally (excluding extreme cases) consolidation has dampening short term effects on output,

contrary to the argument that its confidence building effect might dominate.[1] This is not, of course, an argument against long term fiscal reform and consolidation that can enhance growth, but a caution against abrupt consolidation at a time of fragile recovery.

Against the background of the cooperative scenario put forward by the IMF, a great deal of attention in the process leading up to the Seoul meeting, and during the Seoul meeting itself, has been devoted to the issue of current account imbalances. While there was no agreement on specific quantitative targets in the form of upper bounds on current account deficits and surpluses, as had been proposed by the United States, there was an agreement that large CA imbalances were likely to constitute a threat to global economic stability and that, with the technical help of the IMF, the G20 should try to develop a methodology to analyze the problem further and develop a common approach that could help reduce unsustainable imbalances. Other international institutions, notably the ILO, have been invited to provide input into the MAP and the work of the "Framework Group", and thereby into the analysis of economic policies and their interactions. The US had originally proposed that countries should commit to bringing their CA deficits or surpluses below 4 percent of GDP. Instead, the Seoul meeting ended with an agreement to have the G20 "Framework Group", with input from the IMF and others, produce a set of indicators that would help in evaluating what was—and what was not—an unsustainable or undesirable current account – and let that be a starting point for discussing remedial policy actions. This work on current account imbalances and on "indicators" that would help design a common approach to the problem of how to reduce them, is consistent with the "external re-balancing" requirement stressed by the IMF, as a key feature of the "cooperative scenario" described above.

The follow-up and the content of this work on indicators will be of critical importance to the success of the French Presidency. The G20 have recognized the need for policy coordination. They have agreed to work together towards macroeconomic policies that lead to positive rather than negative spillover effects. They have asked the IMF to play a central analytical and facilitating role in the process, which is entirely appropriate. The door is open for other international institutions also, to bring their expertise and experience to help the MAP. But there does not seem to be, as yet, substantive progress or agreement on the set of indicators that should

1. See Chapter 3 of the October WEO by the IMF and the work by Alberto Alesina, and Alesina and Silvia Ardagna referenced by the IMF.

be put forward, or the analytical framework within which they should be utilized.

The G20 Indicators and wider policy issues

The macroeconomic work feeding into the G20 process has so far, and understandably, been dominated by the central and traditional themes of fiscal policy, monetary policy, and external payment imbalances. The worrisome increases in public indebtedness in many advanced economies as well as the crisis conditions that characterize some peripheral European economies, further point to the need for careful analysis of fiscal policies. I would like to argue, however, that the work on "indicators" called for by the G20, creates a unique opportunity to broaden the policy debate and to include in it more prominently discussion of policy issues relating to employment and income distribution that tend to be neglected, but that are of crucial importance both to the political economy of international policy cooperation, and to the effectiveness of national macroeconomic policies. This broadening must be mindful of avoiding a proliferation of indicators that are not critical to the MAP.

The problem of employment is certainly mentioned in the G20 Communiqué, but it is treated as part of the growth and recovery challenge. There is little analysis of employment issues *per se*.[2] Another key set of concerns, the social safety net and income distribution, is hardly mentioned at all. This is partly due to the understandable focus of the G20 on *interdependence* and *spillover effects*. Employment and income distribution are considered as entirely *domestic* problems, as opposed to current account imbalances, which are by their very essence *international,* or fiscal and monetary policies, which have well recognized spillover effects.

In fact this *separation* of social policies from fiscal and monetary policies is somewhat *artificial*. First, employment concerns are central to overall macroeconomic strategy.[3] The degree of expansiveness or restrictiveness of both fiscal and monetary policies, in any country, has to be responsive to the employment outlook. Consider the situation in the US, for example. Looked at purely from the point of view of the need to reduce its current account deficit, one can argue that the United States should tighten its

2. There are references to the work done by the OECD on labor markets.
3. The centrality of employment to the formulation of macroeconomic policy choices was recognized and discussed in September at a joint ILO–IMF conference in Oslo (see www.osloconference2010.org). As of 2010 the ILO and the IMF have started to work together on employment and social safety floor issues.

macroeconomic policy mix, and focus entirely on a fiscal indicator, such as, say, the path of the primary deficit. But considering that unemployment remains stubbornly above 9.5 percent, with long term unemployment in particular higher than in decades, fiscal tightening in the near future is neither politically feasible nor in fact desirable. It has to be acknowledged, therefore, that fiscal and monetary policies cannot just target the external position, but will remain primarily targeted on domestic conditions, *very much including the employment outlook*. If the US could devise labor market policies that successfully increase employment, this would in turn allow a fiscal and monetary policy mix more conducive to a reduction of global imbalances. Suppose, for example and just to make the point, that the US could have implemented "labor sharing" policies similar to those of Germany, and had maintained, as Germany was able to do, employment levels at close to pre-crisis levels, the fiscal and monetary policy stance that would be feasible and desirable in 2011 in the US, would be very different than it is now. Similar arguments, in a very different national context, could be made for China. The threat of a slowdown in the growth of employment- which despite rapid GDP growth has not been very rapid -is much more worrisome to Chinese policy makers than a temporary loss of two or three percentage points of GDP growth would be. If China is to adopt policies, including exchange rate policies, that encourage a more domestic demand and services (non-tradables) oriented growth pattern, it will first want to reassure itself than no damage would be done to employment creation. This is why employment and labor market analysis must be a *central component of the macroeconomic analysis* supporting the MAP, and not just appear as an add-on or as a separate effort "for Labor Ministers only".

Another important need for some "broadening" of the analysis surrounding the MAP relates to income distribution and its impact on the effectiveness of macroeconomic policies. A current account imbalance necessarily reflects a difference between domestic production (income generated) and absorption (income spent), translating into a difference between domestic savings and investment. Exchange rate policy can only affect the size of a current account surplus or deficit, if it directly or indirectly leads to a change in the difference between savings and investment. The way income is generated before taxes and distributed, both before and after taxes, has an influence on savings and investment behavior, and therefore on the current account. So quite apart from ethical or purely political considerations, income distribution has macroeconomic effects and should therefore, with labor market and employment issues, be part of the issues analyzed to support the MAP. Note in this context, that it

is not the public sector balance alone that determines the current account, but the combination of the public and private sector balances.

The interaction between income distribution, the financial sector, savings and investment, and fiscal policy are complex. It is often argued that a more unequal income distribution is likely to lead to more savings, as the rich save a larger proportion of their incomes. But fiscal incentives and other factors may influence and counterbalance the effect of income distribution. For example, if fiscal incentives and expectations regarding effective demand do not encourage investment, income concentration at the top may lead to lending from the very rich to the lower income groups in a society, encouraging more consumption, intermediated by the financial sector, a process formally modeled in a recent IMF working paper by Kumhoff and Ranciere[4]. In the authors view, the causal chain of increasing income concentration at the top, translating into the offer of complex financial products to investors with many of these facilitating excessive borrowing by the lower income household sector, rather than more productive investment in tradables, was a central cause of the great financial crisis in the US. Raghuram Rajan, in "Fault Lines", puts forward the same narrative in more informal language. Joseph Stiglitz and Robert Reich, as well as others, have argued, in numerous publications, that US income concentration should be a central concern of policy makers, not just for ethical reasons, but in order to increase the effectiveness of macroeconomic policies. Circumstances are of course very different in China, but increasing income concentration as well as well as the weakness of the social safety net, may have been a key reason explaining the very high savings rate, and the strong reliance on export markets to fuel rapid growth in the face of domestic household income and consumption demand not growing as fast as production. In China, it is net exports rather than borrowing by lower income groups that may have compensated for a structural imbalance created by rising inequality.

These income distribution related factors are sometimes included in the macroeconomic work related to the MAP, under the heading of "structural issues". But they deserve a more central place in the analysis and should be carefully considered when proposing packages of fiscal measures and institutional reforms that could lead to global rebalancing and a better outcome for the world economy.

It should be feasible to come up with indicators that encourage a more complete analysis of internal and external imbalances, without letting the

4. Kumhoff, Michael and Romain Ranciere " Inequality, Leverage and Crises" (2010)

list grow and proliferate beyond what is central to key policy choices. The indicators should cover labor force participation and employment, and the nature and composition of unemployment, in as simple a way as possible, as well as key changes in the distribution of income that impact savings and investment. These two or three "social" indicators would be additional to the more traditional indicators restricted to aggregate fiscal balances, debt levels and balance of payments trends. What is more challenging, but very important, will be to integrate these indicators in an analytical framework with behavioral hypotheses that allows the design of well grounded policy recommendations that take into account the social and political feasibility of various policy packages.

Finally, the longer run growth implications of various public expenditure packages should be kept in mind. The effect on debt dynamics and the public sector's balance sheet of public expenditures that build human and physical capital and infrastructure are clearly different than pure public consumption spending.

It is time to deepen and broaden the debate on macroeconomic and fiscal policy, and integrate the analysis of structural issues with the analysis of the traditional aggregates.

A NEW CHALLENGE FOR EUROPE

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Experience is son of hard mistakes. These well-known words of the Russian poet Alexander Pushkin reflect the current situation in Europe. Europeans have just experienced not only a crisis but also a number of attempts to fix it. It is time to reveal major challenges that EC faces.

The "policy trilemma" is the first of them. It is what lay behind the breakdown of the last era of globalization. The real concern is that the crisis bubbling on the other side of the Channel represents a make-or-break moment for globalization. The rule of thumb here is as follows: of the three aims we have been striving towards in recent history – democracy, national sovereignty and global free trade – you cannot have any more than two at any one time. Want to run your country as an independent state, open to the whims and volatility of the free markets? The voters will punish you at the ballot box. Insist that your nation has full control of its own affairs? Then you have to jettison any plans to play a full part in the global economy. Want democracy and globalization? Then you have to suborn your sovereignty.

The second challenge is the threat of crisis to European integration itself. During our discussion we can point out issues related to the causes of the current European financial crisis, its implications for European integration, and possible policy responses.

One of the main lessons of the crisis: European integration must be sped up, not slowed down. It is obvious that the crisis has been a setback, but the benefits of integration are beyond doubt. Europe should build robust integration measures in the face of financial crises. The economic policy can be focused on the measures to reduce the severity or even prevent a crisis.

We can stress a clear need for an integrated European framework for crisis prevention, management, and resolution. The framework could include a European Financial Authority, with the mandate and tools to deal cost-effectively with failing systemic cross-border banks.

Europe should also strengthen economic policy coordination. Currently, the major policy frameworks in Europe—macroeconomic, financial, and structural—are relatively independent of one another. And the next lesson of the crisis is that a single European currency without enough economic policy coordination may lead to huge imbalances.

European countries must work together to sustain the economic recovery. That is the priority. To restore confidence in Europe's fiscal sustainability, policymakers must formulate, communicate and begin to implement strategies for exiting from crisis-related intervention policies as soon as possible.

The policy measures could include enhanced macroeconomic surveillance, particularly on the fiscal impacts of asset cycles, competitiveness, and balance of payment issues, as well as the creation of an integrated supervising system. The challenge lay with the sufficiency of both the domestic and international responses to deal with the next wave of stress.

The third challenge is geopolitical one. The emergence of a US-Chinese duopoly has reduced Europe to a more modest role in world affairs. For all these reasons, Europe is suffering from uncertainty and gloom. The crisis has also revealed serious weaknesses in the EU's institutions. Governments have not respected the stability pact. Deficits in several countries have spun out of control. Although Europe has a single currency, member states have not exercised the discipline necessary to defend it.

The European Commission remained mute when the storm peaked, but eventually hit back by criticizing many EU member states for creating large public deficits. The Commission now claims that 20 of the 27 EU's member states are too deeply in debt and should return as soon as possible to the "reasonable" limits set out in the Growth and Stability Pact. But if European member states follow the Commission's recommendations Europe can be brought to the brink of another crisis.

Europe is also interested in a new leadership related to sovereign defaults. The Stiglitz report gives a detailed description of this pressing topic. One more problem concerns debts of developing countries. The politicians and experts are actively discussing the possibility of cancellation of all debts of less developed countries. However we need to understand could such decision promote the global economic growth.

3. REGULATING THE BANKING AND FINANCIAL SYSTEM

INTERNATIONAL FINANCIAL REGULATION AND SUPERVISION

Marcello DE CECCO – *Scuola Normale Superiore di Pisa & LUISS, Italie*

STRUCTURE UNCERTAINTY AND THE CHALLENGES OF A DYSFUNCTIONAL INTERNATIONAL MONETARY SYSTEM

A PARADOX OF RISK AVERSION

Robert JOHNSON – *Roosevelt Institute*

FINANCIAL REGULATION AND SUPERVISION IN DEVELOPING COUNTRIES

Louis KASEKENDE – *Bank of Uganda*

INTERNATIONAL FINANCIAL REGULATION AND SUPERVISION

Marcello De Cecco
Scuola Normale Superiore di Pisa & LUISS, Italie

According to Rogoff and Reinhardt,"international banking crises are almost invariably followed by sovereign debt crises". Onno Ruding, chirman of CEPS and former Netherlands finance minister, suggests that the causal relationship may be inverted in a further development, as sovereign debt crises in turn become international banking crises. That, of course, is induced by the loss in capital values suffered by the sovereign paper held by domestic and international banks. Thus a dangerous spiral gets started, with cause and effect alternating at each turn between banks and sovereign debt.

The trouble is that the new Basel rules, known as Basel 3 , which have just been agreed upon by represntatives of almost thirty countries, give banks until 2016 to accumulate enough capital to reach the compulsory 7% minimum limit. And this interval is supposed to give them a chance to profit from massive doses of carry trade, transforming cheap short term deposits in currencies like the Yen, the Euro, the Dollar, into holdings of medium and long term sovereign paper, preferably issued by high risk countries, that are, however, too big to fail or small enough to be rescued.

But those sorts of transactions are predicated on the realism of Walt Wriston's famous dictum that "sovereign countries do not fail".

Thus the Basel Committee with one hand gives and with the other takes away. The solution it suggests to revamp banks' profits depends on a condition that sovereign debt is mispriced because there is a pretense that countries can fail, dictating a high interest rate, while countries really do not fail.

Thus far, most countries have never failed. (That, of course, covers the decades after the second world war. Before 1914, as can be checked in

Rogoff and Reinhardt, many countries failed, especially during international financial crises when capital that had been lent by the center to the periphery went suddenly back to the center, sometimes because of interest rates hikes in the center which may have been induced by reasons mostly internal to the center). Nor had most countries, until recently, allowed their own banks to fail. This tradition however was recently broken by Iceland, which did indeed leave its banks to themselves. Moreover, in a few months, several observers (including George Soros) have prognosticated that a new coalition government, coming out of Ireland's election in March, could decide to repudiate its debt (which rose hugely as a result of the Irish government's ill considered 2008 decision to guarantee Irish banks' liabilities). That would also be a first in a number of decades, and it could be preceded by a decision of the same sort on the part of Hungary's populist government. It is worth noting that Irish banks, as well as Greek banks, have very large amounts of national debt among their assets.

It is of the greatest interest, therefore, to see what governments and international institutions have been recently adopting in the field of financial regulation and supervision, in order to prevent exactly the inception of a dangerous spiral as the one just evoked.

It is by now obvious that, at least in the last fifteen years, but probably since the financial liberalisation legislation introduced by Vice president Bush in 1980, the invisible hand, as Ferguson and Johnson imaginatively wrote in a recent article "waved good bye". The failure of the so called market solution in the financial sector at national and international levels, is glaring and just as patent is that of so called self regulation, an expression coined by the US SEC before the crisis. Re-regulation has therefore become imperative, and in Basel, in Bruxelles and in Washington legislators and administrators have been busy devising new rules for the financial system, helped by the FSB and the Group of Twenty.

The so called Basel 3 Rules, as they have been recently published, have made the capital requirements for banks much more stringent, severely curtailing the number of assets which banks can consider as core tier one. In particular, much less space has been given to so called Hybrids like subordinated loans, as it has been discovererd that they often became illiquid just when they were called. In fact, this problem of what may be considered as liquid assets has beleaguered the financial world, especially in Britain and the US, since the late nineteenth century. Short of full bodied metal coins or ingot, or fully convertible legal tender cash, all assets that have a credit nature have a degree of liquidity which is limited by the probability that they be given back to the lender in full and at call and by the depth width and resiliency of the market.

This drastic reduction of the quality and quantity of fully liquid assets has been conveniently overlooked especially at times of financial euphoria, with the result that banking systems have acquired the shape of great inverted pyramids erected on very shaky foundations.

The problem has become much more serious now that so little money is constituted by cash, most of it being bank money and electronic money. What XIXth century economists called the monetary system's keel has therefore become ever lighter and easy to get out of balance. We are approaching what can be called fully wicksellian monetary systems.

Now, after the great disaster of 2007-08, an attempt is being made to increase the ballast and give the system a more even keel. But will the system's private and public operators , at national and international level, resist the temptation of having their cake and eating it, which is what extending the definition of liquid assets traditionally means? The resistance put up by the banks against the more exacting rules contained in the early drafts of the US financial reform bill is evidence of the enmity of banks and other financial institutions to serious regulation. That this is not just an idiosyncratic prerogative of US banks is shown by the cautious approach in Basel and Bruxelles (and by the FSB), to maximum leverage rules and by the fight, as Sheila Bair noted in a recent interview, over the 8% capital requirement, reduced to 7%.

Since the publication of Murdock Helmann and Stiglitz, ten years ago, and the literature based on that seminal article, we also know that capital requirements may be even counterproductive, as banking is not a business like most others and capital requirements may push banks to go for riskier assets, in order to maintain their profit rates. Profits per share, we must remember, are the normal basis for stock exchange values and the Basel 3 rules rightly consider equity capital as the only core capital. More profits per share normally means higher stock exchange valuations, hence greater ease for banks to raise capital via the stock exchange.

Here is another contradicition, therefore, between what the new rules want to achieve (a stable and secure financial system) and the way they suggest to achieve it.

A solution may be found in allowing, as Freixas and Parigi suggested in a paper a few years ago, banks to own certain types of risky and remunerative assets only if they are highly capitalised, while if they have less tier one core capital, they may be barred from owning those assets. This is a variation on the Volcker rule, one of the many possible ones.

A more drastic suggestion is that capital is not a substitute for hands-on direct supervision, of the sort that was more frequently practiced in Europe

and US until the liberalization process began. This, of course, is a sort of reasoning similar to the one which sees banking as essentially different from the type of insurance which tries to deal with strong uncertainty by pooling insurers prepared to just bet, without giving much consideration to parascientifically calculated odds.

But direct supervision, by inspecting the premises of banks and financial insitutions and poring over their books, requires the sort of ethics of public employment according to which money is not the only status conferring vehicle. It has been noticed that this sort of public morality has been on the vane in the last few decades, and that clever young people have only very infrequently taken up public service careers after leaving college, much preferring the high wages and high living offered by financial sector employment.

In the last three years, as a result of the international crisis, parliaments have been more sensitive to a swing of opinion in favour of greater regulation. Hence the passing of laws like the recent financial reform bill by the US Congress and the even more recent one introducing the European Supervisory Authorities by the European Parliament. They both seem to be less indulgent towards financial institutions than the rulebook called Basel 3. The latter, in fact, still puts rating agencies, whose record in the crisis has been much below expectations, at the basis of most financial valuation processes. And it maintains the internal risk assessment methods for large banks, which was introduced by Basel 2 and made a very poor show of itself in the crisis.

Neither the FSB nor the three ESAs, moreover, provide a well specified and directly applicable procedure for the resolution of large and complex financial institutions.

Nor do they radically address systemic risk, which can be present, as we painfully know, even in the case when liquidity requirements are satisfied by all operators in the system.

There is a high chance that in coming months we shall see large problems, which will most probably return on the international financial scene, being addressed rather than by rules, by ad hoc solutions painfully arrived at in hastily convened international meetings of administrative and political authorities.

Meanwhile, some countries have resorted to purely national solutions to address problems issuing from the very high amount mobility and volatility of international short term capital, which, as in the 1920s and 1930s, tends to nullify their anti- inflationary monetary policies. Such is the case, for instance, of South Korea, where a tax on international capital

has been introduced, aimed at discouraging inward capital flows and whose revenue will be destined to a fund to be used to address problems that may affect the financial system in the future.

A variation of this tax could also be introduced, transforming it into a financial transactions tax, to provide resources to a fund that might repurchase national debt to keep it from falling to very low levels on the open market. In this fashion, for instance, it might replace the interventions to buy risky countries' debt which are being conducted by the ECB and are becoming too large and too frequent.

Of course, this last mechanism would work much more effectively if it were planned and executed at EU or even at OECD or IMF level. By allowing a work out of large amounts of national debt, it might lift the pressure from national budgets and in due course transform the Ruding vicious circle into a virtuous one.

STRUCTURAL UNCERTAINTY AND THE CHALLENGES OF A DYSFUNCTIONAL INTERNATIONAL MONETARY SYSTEM

A PARADOX OF RISK AVERSION

Robert JOHNSON
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The Sovereign Wealth Funds are entrusted with managing the risk/returns for their citizens in the current anxious environment. It is not surprising that investors charged with this task during a time of structural unraveling respond to the Knightian uncertainty and political discord by seeking safety.[5] Any given small investor by herself would be rational in "seeking a port in a storm", but when looking at the size of the accumulated holdings of the emerging countries, one cannot help wonder if we are on the brink of a collective "paradox of risk aversion" that is analogous to Keynes's paradox of thrift.

Financial theorists characteristically consider the distribution of risk and reward as exogenous. When we pass from the realm of structural economic analysis through the curtain and emerge into the domain of quantitative finance theory, we rarely translate our structural parameters into the higher moments of the statistical distributions. Yet, as we learned when AIG underpriced credit default swaps in 2006-8, the collective behavior of financiers does tend to morph the statistical distributions, meaning that the distribution itself becomes endogenous. [6]

It is in this spirit that I am asking whether, collectively, the safety seekers managing the large funds of the surplus countries do not together present

5. See Ben Bernanke "Irreversibility, Uncertainty, and Cyclical Investment," *The Quarterly Journal of Economics*, MIT Press, vol. 98(1), pages 85-106, February. 1983
6. See the writings of Perry Mehrling on this question. In particular his paper entitled, "The Global Credit Crisis and Policy Response(2009) at http://www.econ.barnard.columbia.edu/faculty/mehrling/Global_Credit_Crisis_and_Policy%20Response.pdf

the world macro/monetary system with an impossible task that heightens our structural uncertainty, political discord, and the resulting riskiness of our financial assets, whether stocks, bonds, currencies, or even sovereign credit. Do we experience a paradox of risk aversion by all trying to hold the safest assets? Are we not collectively fighting in the tension between financial sustainability and social/political sustainability that late Tommaso Padoa Schioppa wrote about in his paper "The Ghost of Bancor"?[7]

One leader of an Asian fund described the challenge to me as rolling a dime down a saddle. Ordinarily there is a large flat runway on the top of the saddle with deflation and runaway inflation at remote distance from the plateau. In the current context, the plateau narrows to a knife's edge and the difference between deflation and inflationary trajectories is very narrow. Why are these seeming polar extremes both considered feasible in the current context? I believe it is because we are in a rare period of structural disequilibrium in the world economy not unlike the interwar period when the leadership of the world economic system passed from the United Kingdom to the United States. We are not in a period when expectations can be easily and stably formed. This complicates the challenge that protecting wealth entails.

Furthermore, in this instance, the very effort to preserve wealth by a concentrated group of investors with large holdings may actually make things more fragile and unstable. Not everyone can be safe in accumulating wealth. To paraphrase Martin Wolf, the question is: how will surpluses of accumulated wealth be destroyed? The degree of wealth destruction is not known or predetermined *ex ante*. The sovereign wealth funds are not small atomistic actors in the world system. While everyone can feel small in the sea of international capital flows, I will conclude that the management of large aggregations of sovereign wealth is tantamount to an oligopoly problem with cooperative and non-cooperative outcomes that are inherently unstable. (Cooperative outcomes invite cheating if one cannot easily detect noncompliance). Yet the redirection of these large surplus flows from the sanctuaries of sovereign debt into channels of expanding risk and investment has the potential to play a key role in moving the world economy from the trajectory of austerity and dysfunction to one of greater growth and prosperity. The adverse feedback loop where fear creates risk aversion, and risk aversion leads to an investment pattern that is socially destabilizing, which in turn heightens risk aversion, can be reversed. Sovereign investors, through their actions, could alleviate some

7. See The Ghost of Bancor at http://www.uclouvain.be/cps/ucl/doc/triffin/documents/TPS_EN_finale_clean.pdf

of the fear and uncertainty that currently drives the propensity to be risk averse in investment behavior.

Radical Uncertainty: The Dark Knight of the Investment Soul

The concept of Knightian Uncertainty was developed in a period of structural turmoil following the First World War (Frank Knight, Keynes in his *Treatise on Probability*, and Hayek all saw the world through similar lenses at that time). Similarly, we are now in a period when the "unknown unknowns" loom large in our world economy. While I think these concerns are relevant to nearly all of the developed economies in the world, I will explore this particular challenge from the vantage point of the United States, which has been at the center of the world system since the 1940s. The turmoil in that country is, I believe, the most threatening to system coherence in the coming period.

Charles Kindleberger, the man who inspired me to become an economist when I was an undergraduate at M.I.T., wrote on the Great Depression and posited that the dysfunction of the world system at that time was the result of the center of power no longer being able to provide the "public good" of residual stability.[8] In some respects, the United States is now in a position similar to that of Great Britain in the Interwar period. Meanwhile, China appears to be the advancing center. Note that the transition from Britain to the USA was between two cultures that had deep similarities in philosophy and tradition. A transition from U.S. to Chinese leadership may not be endowed with these cultural understandings, and this could make such an adjustment much more challenging. If one models this challenge as a cooperative game with incomplete information, it could be said that the ability to understand the reaction function of the other player would be more difficult to discern and achieving cooperative outcomes more difficult.

Zbigniew Brzezinski recently gave a speech at the Council on Foreign Relations that highlighted two ominous themes.[9] First, the structure of power had changed from roughly a North Atlantic Alliance to the G20. That the structure and distribution power was changed was not dangerous

8. See "The World in Depression, 1929-39", by Charles P. Kindleberger, University of California Press. The culminating argument of the book is online at http://www.mtholyoke.edu/acad/intrel/depress.htm
9. See Zbigniew Brzezinski's talk at the Council on Foreign Relations May 18, 2010 online at: http://dailybail.com/home/nwo-exposed-in-cfr-speech-brzezinski-warns-political-awakeni.html

in and of itself, but the fact that there was not a design for an orderly system upon which all elites could agree, was very dangerous.

Second, Brzezinski expressed the view that the spillovers from the excesses of the financial sector culminating in the Crisis of 2008 had caused great losses for many across the planet. The ugly nature of the way public balance sheets were used to keep the financial system from collapsing, while necessary, appears to have ignited the rage of the body politic in many parts of the world, perhaps most importantly in the United States, which is has been the lynchpin of the world economy in the previous epoch.

One need not argue whether the bailouts were necessary. I believe they were. But as they say, there are ways, and there are ways—and the most recent episode was a way that inflamed the public. We have been through an episode in which we made the abused body politic pay the perpetrators, rather than proceed as we did during the S&L bailout, where wiping out or dilution of stock, changing management, criminal prosecutions, and restructuring of creditors dominated the resolution process. That the United States government, through TARP and thereafter, seemed very able to mobilize large-scale funds on very short notice and rescue the financial system was a good thing. That it seems only able to do this in response to, and on behalf of, a powerful financial elite has set in motion some very sour psychology that is likely to heighten our sense of Knightian Uncertainty for a long time to come. As Amartya Sen illustrated in a convening of economic historians I attended at Harvard in the spring of 2010, to do the bailouts was a cooperative game in the sense that we lost less than was possible. Yet the distribution of the burden of moving us to the cooperative outcome sowed the seeds of distrust for the repeated games of governance that would follow. The financial leaders made a very strong and accurate case that they must be rescued because they could take the economy down with them. But this notion now stands in stark contradiction to the complacency that Wall Street leaders demonstrate with regard to persistent joblessness in America and the resistance that they exhibit to financial regulation proposals that would restrain their capacity to spillover onto the real economy in the ways they acknowledged during the depths of the crisis. It appears to the public that Washington is very responsive to Wall Street and that we are "all in this together" only when the financial sector is in extreme jeopardy. [10]

10. This bold revelation of where power lies in U.S. society is reminiscent of the forebodings of Herman Melville who warned of the discouragement of society when it was revealed starkly that society did not operate according to the democratic premise that "all men are

One can see some of what Brzezinski was referring to by looking at the recent polling on the impact of U.S. government policies done by the Pew Foundation in July of this year.

Two tables make the point:

Government policies seen as doing little for the poor, middle class, small business

Gov't econ policies have helped....	Great deal (%)	Fair amount (%)	Not too much/at all (%)	DK (%)
Large banks and financial institutions	53	21	18	8=100
Large corporations	44	26	20	10=100
Wealthy people	31	26	30	12=100
Poor people	7	24	64	5=100
Middle class people	2	25	68	4=100
Small businesses	2	21	68	8=100

Source : Pew Research Center/National Journal July 15-18, 2010.

Who's been helped by economic policies?

Percent who say each has been helped a great deal/fait amount by the federal government's economic policies since 2008

	Total (%)	Rep (%)	Dem (%)	Ind (%)	D-R diff
Wealthy people	57	45	67	58	+22
Middle class people	27	16	37	28	+21
Small business	23	14	35	21	+21
Large corporations	70	61	74	74	+13
Poor people	31	33	33	29	0
Large banks and financial institutions	74	75	73	77	-2

Source : Pew Research Center/National Journal July 15-18, 2010.

created equal". Melville's poem "Clarel", written late in his life, explored these tensions. William Sloane Coffin, the American theologian, also referred to Melville when he wrote:
But today, because we have so cruelly separated freedom from virtue, because we define freedom in a morally inferior way, our country is stalled in what Herman Melville call the "Dark Ages of Democracy," a time when, as he predicted, the New Jerusalem would turn into Babylon, and Americans would feel "the arrest of hope's advance."

After the creditors of heavily leveraged financial institutions were bailed out and the public balance sheet was expanded to stem the financial crisis, we are now entering a period when many people are rebelling against further use of the public balance sheet to support anything, including the real economy via infrastructure repair or other forms of stimulative deficit spending. In a sense, the rise of the debt/GDP ratio in the U.S. and other developed countries, coupled with the particularly difficult digestion of the distributional nature of the bailouts, has damaged the public's trust in the capacity of government to manage the economy. It has reinforced in the mind of the citizens Ronald Reagan's claim that government is the problem, not the solution. At a time when persistent unemployment is near 10 percent in official numbers, and those not working are a far greater percentage of the workforce, it would seem an obvious time to rebuild infrastructure and to emerge from the slump. Following the lessons of the Great Depression and the example of the New Deal, one would think we would have a broad social consensus for such action. Yet such an assumption does not take into account the deterioration of trust we have experienced or the success of persuasive forces in denigrating the capacities of government.[11]

Harold James, the historian at Princeton University, has written in his most recent book of how the deterioration of trust following a financial crisis renders government-centered efforts impotent.[12] Not only is economic value destroyed in the acute downturn of the economy, but the capacity to function as a society experiencing market dysfunction is devastated too. Human values are destroyed along with economic value. James likens the crisis of 2008 to the banking crisis in Germany in 1931, and in his previous work on the German Slump he studies how parliamentary and interest group struggles lead to extreme government paralysis and dysfunction. [13]

11. The notion of persuasive forces that may or may not be creating perceptions that corresponded to "Truth" is explored in great detail by George Soros in his Budapest Lectures and in his essay, "What I Did Not Know: Open Society Reconsidered", in What Orwell Didn't Know: Propaganda and the New Face of American Politics, Public Affairs Books, edited by Andras Szanto. Soros differentiates between the cognitive function, where learning the truth allows an individual to better understand and operate in the environment, and the manipulative function, where the strategy of altering the perceptions of other people so that they advocate actions that make the manipulator better off.
12. See "The Creation and Destruction of Value: The Globalization Cycle" by Harold James, Harvard University Press (2009). See particularly his chapter comparing 2008 to 1931 rather than 1929. Also see the concluding chapter.
13. See The German Slump: Politics and Economics 1924-1936. Oxford University Press 1986. See also Walter Dean Burnham's excellent paper on Weimar politics entitled, "Political Immunization and Political Confessionalism: The United States and Weimar Germany, Journal of Interdisciplinary History, Vol. 3, No. 1 (Summer, 1972), pp. 1-30

One locus of the dysfunction is the federal budget, and the problem may be civil, not just financial. Asset management consultant Robert Dugger, in testimony to the National Commission on Budget Responsibility and Reform, expressed the view that budgets are only in part about money.[14] They express the fabric of civil commitments that citizens have made to each other over many decades. Those commitments—public safety, education, good roads, freedom from government over-regulation, and reasonable taxes—are built into local, state and federal budgets. People organized their families and businesses around these commitments. The very slowness with which they accumulated and were reaffirmed year after year in budget legislation attested to their firmness and reassured people they could safely organize our lives around them.

For Dugger, a budget crisis is a crisis not because there is not enough money. It is a crisis because the fabric of our society is being ripped apart, threatening families and businesses. To restore trust and assure voters that the fabric of society will be preserved, a commitment, must be found—a commitment so compelling that if voters can be assured this commitment will be met, they will be agreeable to adjusting the others and to constructing a new fabric of civil relationships peacefully and cooperatively.

The economic and budgetary dysfunction we are seeing in the United States is in some ways similar to James' scenario. The impending loss of trust in government, and the anti-incumbent nature of the current popular sentiment, will to put the Obama Administration into a much weaker position following the November election. However, it must be said that this is not a simple Democrats vs. Republican issue. Within the Democratic Party, this debate is raging all by itself.

Many economists are currently engaged in the fight over the magnitude of the Keynesian multiplier and other rituals about the efficacy of fiscal policy. The body of evidence, I believe, suggests that it is at times like these, with lots of slack in the economy, that the impact can be quite significant. Yet that is not the fight that I believe is really taking place. The "small multiplier" economists are just the current intellectual advance troops of the major fight in the United States about the size and role of government. Whether government stimulus works or not, and whether or not infrastructure augments productivity and private investment is crowded in or out, is of little matter to those who, as a matter of philosophy, do not

14. See, Robert Dugger's "Testimony to the National Commission on Fiscal Responsibility and Reform". June 30, 2010. http://www.hanoverinvest.com/pdf/TestimonyFiscal Responsibility Commission100630.pdf

want to see government play a major role in the economy. They are willing to endure the seemingly unnecessary short-term pain of a slump to purge American society of the dreaded government.

This is a major conflict, and with the Republicans having gained ground in November, we are likely to see this fierce battle continue. The stalemate will, in the sense of Kindleberger, likely render the center reserve currency country of the international monetary system more unstable because the essential degree of freedom and fiscal policy that must now be used to maintain aggregate demand in light of interest rates being at the zero lower bound will be unavailable as the "conflict of visions" in the United States plays out. In the following section I will argue that this stalemate is what will make the international monetary system very unstable and uncertain. A look over to Europe and its similarly vigorous efforts at fiscal consolidation implies that the alternative to the dollar, the euro, is unlikely to be able to help balance the system, either.

The International Monetary System Dysfunction

The world economic structure has been based on a regime of export-led growth to the United States since WWII. The American market has been the buyer of last resort. The rise in private indebtedness of U.S. households on the back of the housing boom and decline of the U.S. savings rate gave that structure a burst of energy that came to a halt with the crisis of 2008. More ominous is the reality that expanding consumer spending was accompanied by declining real incomes for many Americans as any given dollar of income was supported by more and more credit.

At the same time, our open free trade system has favored outsourcing and offshoring of key elements of the production process that tended to put pressure on wage and compensation growth. This pressure on American consumers surged at the time of NAFTA and accelerated with the development of China and India in recent years. This contradicts the long-term notion of U.S. consumers being able to sustain their role as the buyer of last resort. Compressions of incomes for large portions of the U.S. population that resulted from competition with low wage regions of the world was incompatible with the maintaining the vitality of U.S consumption and export-led growth for everyone else. For a time, the credit innovations delayed a reckoning, but that systemic contradiction is now exploding into full bloom with the collapse of the consumer credit pump. This shock to the pattern and magnitude of global aggregate demand is, to my mind, the fundamental deflationary impulse that the world is now ill-equipped to address. We were dependent on this structure of trade for a very

long time, and the financial debt bubbles suggest that we are not in a typical cyclical situation. It will take many years to rebalance the system, and that altered trajectory is now very stressfully beginning to work itself out.

Some economic commentators have seen on the distant horizon that a rebalancing of demand in the emerging markets involving less export led growth and more domestic development and spending is the path to harmonization of the world system. Unfortunately, the components of aggregate demand are not quite so protean in any significant shorter time frame. Regimes that are predicated on export-led growth involve a system of tax, subsidy, regulation and other structural priorities that are not easily shifted. It often requires a drastic realignment of domestic politics to shift from export-led growth to domestic-driven growth or vice versa. Powerful groups within the domestic political economy are put into conflict with each other. The timing of the resolution, no less than the shape of the outcome itself, is not at all clear.[15]

That is the dimension of uncertainty that the international monetary system is coping with as we look toward the future. One could see that the scale of imbalances, as measured by the degree of reserve accumulation in the surplus countries, has been soaring. With the U.S. dollar having many features that have given it the dominant structural role as the reserve currency, most importantly the broad, deep and transparent government bond market with the availability of the full spectrum of maturities, much of the reserve accumulation was recycled to the U.S. dollar and the U.S. Treasury market in particular.

For several years, particularly since the end of the Asian crisis in the late 1990s, rising surpluses (U.S. deficits) and the recycling of surpluses back into dollar denominated securities served to raise the foreign exchange value of the dollar, and added a deflationary impulse to aggregate demand in the United States. The Federal Reserve was able to offset this by lowering interest rates to manage its mandate of full employment and price stability.[16] In analytical terms there is an iso-demand curve in exchange rate/interest rate space that led to a combination of stronger dollar and lower interest rates to keep the U.S. macroeconomic system in a distorted form of balance. Large private imbalances with a dearth of savings, rising government deficits, and large current account deficits have been the American pattern.

15. See Mancur Olson's book, "The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities", Yale University Press: 1984.
16. See Martin Wolf's book, "Fixing Global Finance", Johns Hopkins Press: 2010 for the elaboration of this argument.

That ability of the Fed to act as the balancing agent has come into question now with interest rates at the zero. The collapse of the securitization and consumer finance markets in the USA has damaged the U.S. buyer of last resort system of world commerce and has set in motion a musical chairs game in the international monetary system of passing the deflationary hot potato around. Deficient demand worldwide is being redistributed. The mercantilist tendency around the world of exporting deflation through exchange rate management often then cycles back to the U.S. economy, but the Federal Reserve is unable to offset this now at the zero lower bound of interest rates. As the European tensions over Greece and the other peripheral countries came to the fore earlier this year and showed how inferior the credit market structure of Europe is to the sovereign debt market of the United States (and Japan), the upward pressure on the dollar was compounded for a time and could not be offset with lower interest rates.

The deflationary shock to U.S. aggregate demand, emanating from beggar-thy-neighbor exchange rate policies and the self-insurance behavior of surplus countries that leads to reserve building could theoretically be offset by the instrument of macroeconomic policy-fiscal expansion. A larger public works infrastructure project for the American economy could accomplish this if the political consensus were to exist, and that program could permit the U.S. to absorb some deflationary shock and could buy time for the transformation of the world economy. Fiscal policy could be the residual balancing element that monetary policy has been in response to the accumulation of dollar reserves by foreign governments. Yet in the current gridlock and conflict over the role of government in the United States, that component of aggregate demand cannot be as responsive as the Fed-interest rate mechanism has been until we hit the zero lower bound.

I note here that the scenarios of quantitative easing by the United States that are widely covered in speeches and the media are a different type of adjustment mechanism and a U.S.-only QE initiative may be tantamount to exporting deflation back out from the United States into the rest of the world.

At a deeper level, this international monetary dysfunction and the management of nominal exchange rates by many of the mercantilist minded export-led growth economies may be tantamount to letting real variables adjust via inflation differentials rather than nominal exchange rates. Efforts to resist exchange rate appreciation may lead to rising asset price inflation and eventually goods price inflation in some of the surplus nations. Suffice it to say that in the present situation, China, Japan,

Germany, and many of the rising countries of Asia cannot all be export-led growth surplus nations when the U.S. grinds down to moderate deflation as a result of the retrenchment of the household balance sheet as the paradox of thrift tightens its grip on the frightened American citizen. Inflation in the emerging markets and deflation in the developed world are the results of this dysfunctional exchange rate pegging and reserve accumulation system that strives to protect the export strength in the emerging world that continues to accumulate a "self insurance" war chest of reserves to protect the emerging nations from the violence of the international capital markets. Both sides of the saddle I mentioned in the introduction are before our eyes simultaneously: deflation in the developed world and bubble-building inflationary forces in the emerging countries that defend their export sector. In addition, the tendency of the large developed countries to accumulate private and sovereign debt to ward off deflation may at some point lead to a drive for inflation to lighten that burden. It is unlikely that this system of imbalances will alleviate the uncertainty that breeds caution. It is also likely that fear and caution will lead to investment behavior that exacerbates structural uncertainty. We likely require both political and financial leadership that is currently in short supply before we can move to a systemic logic that transitions from the Dark Knightian anxiety of uncertainty and sheds light on a path that coheres.

Sovereign Wealth Funds: A Collective Paradox of Risk Aversion?

Can an international monetary system withstand such large flow imbalances as we have seen in the last 10 years on an ongoing basis? And can the system cope with a recycling of imbalances of these magnitudes into the riskless asset? Writers such as Charles Dumas of Lombard Street Research, in his new book entitled "Globalization Fractures", suggest that the key to adjustment in the face of the deficient aggregate demand caused by the exhaustion and retrenchment of the American consumer must take two dimensions. First is the reduction of the scale of those imbalances. Second is a cessation of the degree of risk aversion on the part of those investing what imbalances do remain to be recycled. [17]

To alleviate what Ricardo Caballero refers to as the excess demand for safe assets, several responses can be pursued.[18] First, the sovereign wealth

17. See "Globalization Fractures: How Major Nations' Interests are Now in Conflict", by Charles Dumas. Profile Books: 2010.
18. See "The "Other" Imbalance and the Financial Crisis", by Ricardo Caballero. M.I.T. Working Paper 9/32 2009. Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1529764

funds could directly invest in more risky assets. They could move into equity or even direct investments in greater proportions. Obviously, given the sheer size of their investment capacity, it would entail some loss of liquidity. It would also involve what might be a good long-term investment in human capital in assessing more complex or information-intensive asset classes from within their institutions.

Second, the United States government could intermediate and buy riskier assets or make direct investments with the proceeds of its bond sales to the surplus countries. This would be somewhat difficult to achieve, given the American aversion to belief in the ability of the government to allocate capital efficiently. Though an infrastructure bank could be developed with private sector board and experienced financiers to provide the needed risk transformation services, it would likely face steep opposition from those who are enraged by the coexistence of the GSEs Freddie Mac and Fannie Mae with the housing related crisis. Setting up new government institutions to intermediate credit is likely to be a difficult task when the losses on the balance sheet of Freddie and Fannie become more and more evident to the public in the coming months. [19]

Third, a public guarantee could be issued to support private risk transformation services on a large scale. This pathway is likely to be complicated by public aversion to giving any more support to the well-paid executives of financial institutions who were paid with taxpayer funds to clean up the mess that they made. Beyond the politics, there is also the question of whether investors would support these institutions that have lost a great deal of the world's confidence in an aggressive program to provide risk transformation services.[20]

19. On the role of Freddie and Fannie in the crisis. see Thomas Ferguson and Robert Johnson, "Too Big to Bail: The 'Paulson Put,' Presidential Politics, and the Global Financial Meltdown" in the *International Journal of Political Economy*, Spring, Part I, and Summer Part II, 2009.
20. On U.S balance of payments and transformation services see Caballero op cit. and also "From World Banker to World Venture Capitalist: The US External Adjustment and the Exorbitant Privilege", by Helene Rey and P.O. Gourinchas, in 'G7 Current Account Imbalances: Sustainability and Adjustment', Richard Clarida, Editor, The University of Chicago Press, 2007.

Conclusion
Can We Break Out of the Paradox of Risk Aversion?

I do believe that we are on an unsustainable path and that the United States will not, despite the logic of possibility, be able to provide the balancing role for the international monetary system in the coming period. Perhaps the best we can hope for is a system where America does not suffer the deflationary consequences of the mercantilist competition of the surplus countries and uses monetary policy to re-export deflation. But as I watch the debates favoring austerity in the U.S. and Europe, and I imagine central banks in the developed world pumping more liquidity into the system in response to U.S. quantitative easing, I can only envision this effort collectively as one that builds an even bigger bubble in asset and commodity markets to try and induce a wealth effect that stimulates consumption. That process seems well underway and it has reduced the cost of debt services while encouraging an ever-greater mountain of debt when business, household, and government debts are added together.

It seems to me that what is needed in the developed countries is not bubbles or austerity but a policy constellation directly targeted on investment spending, human capital investment, a modernization of the supply side, and a focus on productivity growth to inspire confidence the sovereign debt to GDP ratios can be managed. It is on that trajectory, rather than on one of austerity, that we can restore confidence. The question is: who will make the first move in that direction if the United States government cannot because of its peculiar struggles? Perhaps this time the bold endeavors will emanate from a new leadership coalition that uses the growing sophistication at the sovereign wealth funds as the vanguard of constructive change.[21, 22]

21. See Felix Rohatyn's Bold Endeavors for a number of examples of system changing large-scale productivity enhancing government investment programs.
22. For more on the U.S. budget challenge see the White Papers from the Roosevelt Institute by Joseph Stiglitz, and Thomas Ferguson and Robert Johnson at: http://www.rooseveltinstitute.org/Dec_2_Discussion#Synopsis

FINANCIAL REGULATION AND SUPERVISION IN DEVELOPING COUNTRIES

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An important lesson of the global crisis is that a liberalised financial sector is vulnerable to systemic financial crisis which has the potential to inflict enormous cost on the real economy, in terms of lost output and employment and fiscal costs. Although most developing countries were able to avoid serious contagion from the recent global financial crisis, they have suffered from systemic financial crises in the recent past, notably in Latin America and East Asia in the second half of the 1990s. Global efforts to strengthen financial regulation are, therefore, relevant for developing countries. Also of relevance is the need to re-evaluate financial sector strategies more generally and, in particular, to determine the appropriate balance between financial liberalisation and government regulation, whether for prudential or economic motives.

The G20 asked the Basel Committee on Banking Supervision (BCBS) to formulate proposals for reform of global standards for the regulation of banks. The BCBS submitted its proposals in October and these were agreed by the G20 in November 2010. The reforms, dubbed "Basel III", include higher minimum equity and tier 1 capital requirements for banks, the introduction of a capital conservation buffer, stricter definitions of equity capital, the introduction of a non risk weighted leverage ratio, two new liquidity requirements and a countercyclical capital buffer which can be imposed at the discretion of national regulators to restrain excessive credit growth. They will be phased in over the period 2013-19. The reforms are very narrow in scope, and do not tackle some key regulatory issues, notably the question of the appropriate boundaries in terms of permissible business activities of banks which take deposits and enjoy the umbrella of government deposit protection schemes.

Basel III is primarily a response to the perceived weaknesses of financial regulation in developed economies. Although developing countries are represented on the BCBS, representation is mainly confined to the larger emerging markets and the only African representation is that of South Africa. Consequently, global standards for bank regulation do not fully reflect the needs of developing countries. This is also evident in the Basel III reforms, which do not adequately address the regulatory challenges facing developing countries, in several key respects.

Raising the minimum capital requirements is unlikely to be sufficient to ensure that banks in developing countries can absorb the losses from major adverse shocks to their balance sheets and remain solvent. This is because the volatility of the value of their assets is much greater than that of their counterparts in developed economies, and hence their potential losses are much larger. As such capital requirements in developing countries need to be complemented with regulations to curb the riskiness of banks' asset portfolios, such as restrictions on loan concentration. This must be backed up by more effective supervision, including on-site bank inspections, to verify that banks comply with prudential regulations. Bank regulators should adopt a more intrusive approach to supervision, intensifying on-site bank examinations and placing less trust in banks' internal risk management systems and controls.

Financial crises in developing countries have often been associated with balance of payments (BOP) crises. The growing integration of the financial systems of developing countries into global financial markets has heightened their vulnerability to systemic risks. The very low interest rates currently prevailing in developed countries provide a strong incentive for capital to flow into developing countries in search of higher yields. Short term capital flows to developing countries are often very volatile and sharp reversals of capital inflows ("sudden stops") can generate both BOP crises and liquidity crises in the domestic banking system. In addition, a sharp depreciation of the real exchange rate can bankrupt domestic borrowers whose liabilities are denominated in foreign currency and hence generate losses for domestic banks which have extended credit to them.

The reforms to global bank regulation do not address the risks to financial stability arising from volatile external capital flows intermediated through the domestic financial system, but policymakers in developing countries cannot prudently ignore these risks. Designing effective micro-prudential and macro-prudential policy measures to protect the domestic financial sector and the economy from the adverse consequences of volatile capital flows should be a priority.

Policymakers should re-evaluate the efficacy of applying some form of controls or taxes on short term capital inflows. The unwinding of the large macroeconomic imbalances which characterise the global economy in the years ahead is likely to exacerbate volatility in exchange rates across the globe. The exchange rate will be a channel through which global instability will be transmitted to the domestic economies of developing countries. It is well known that policymakers cannot target both domestic variables and the exchange rate simultaneously if the capital account is fully open. Consequently stabilisation of the domestic economy in developing countries, in the face of instability transmitted from the rest of the world through international capital flows, may only be possible if there are controls of some sort on capital flows, especially short term portfolio flows.

The last 20 years has witnessed a general trend towards the liberalisation of restrictions on what banks are allowed to do. Regulations have been liberalised in many countries to allow banks to engage in a range of "non bank" financial activities, such as investment banking and insurance, motivated by a belief that market forces should dictate what types of financial services banks should provide. The global financial crisis exposed the shortcomings of this belief. Some of the major bank failures in developed economies were the result of risks incurred in activities outside of traditional commercial banking, such as investment in complex securities. Moreover, the benefits in terms of economic welfare of the exponential growth of trading activities by banks is not self evident.

For policymakers in developing countries two issues related to the permissible activities of banks are critical. First, should bank regulation restrict banks from specific types of non bank financial business because the risks of these activities, which might be difficult to understand, monitor and quantify, could undermine financial stability? Secondly, are there specific financial services which are important for economic development – for example lending to private investors in emerging sectors of the economy – which cannot be supplied on a purely commercial basis in a market oriented financial sector because of market imperfections of some sort (which may lie outside the financial sector)? If so, there may be grounds for governments to intervene to ensure that these financial services are supplied in the optimal manner, although there are clearly practical difficulties with such intervention.

As noted above, the post-crisis global economic environment threatens to be much more volatile than the period which preceded the global economic crisis. Accordingly, developing countries are likely to be buffeted by major external shocks, which will affect their balance of payments and, through the BOP, their financial systems and their domestic economies. In

such circumstances, access to quick disbursing BOP support could play a valuable role in helping developing countries adjust to the shocks. Both the IMF and the African Development Bank responded to the global economic crisis by setting up new lending facilities for countries facing temporary BOP difficulties. The IMF established the Exogenous Shocks Facility and the AfDB established the Emergency Liquidity Facility. Such facilities will also be important to help developing countries bridge temporary funding gaps which arise when access to commercial finance (such as trade finance) is disrupted, as happened during the global financial crisis. However, the usefulness of these facilities is dependent upon their being made available to developing countries quickly and with the minimum of conditions when the need arises.

4. REFORMING THE INTERNATIONAL MONETARY SYSTEM

REFORMING THE INTERNATIONAL MONETARY & FINANCIAL ARCHITECTURE

José Antonio OCAMPO – *Columbia University*

REGIONAL AND GLOBAL LIQUIDITY ARRANGEMENTS FOR A MORE DEMOCRATIC WORLD

THE POTENTIAL OF SDR'S

Pedro PAEZ PEREZ – *Equateur*

THE REFORM OF THE INTERNATIONAL MONETARY SYSTEM

GOING SLOWLY

Henri BOURGUINAT – *Bordeaux University*

A NOTE ON THE INTERNATIONAL MONETARY PROBLEM

Avinash PERSAUD – *OECD*

REFORMING THE INTERNATIONAL MONETARY AND FINANCIAL ARCHITECTURE

José Antonio OCAMPO
Columbia

The context

The recent global financial crisis showed how dysfunctional the current international monetary and financial architecture is for managing today's global economy. The calls for and steps taken to reform such architecture are, therefore, welcome. Similar calls for reform were made after the sequence of Asian, Russian and Latin American crises of the late 20th century, but they led at best to marginal reforms. The fact that this time industrial countries have been at the center of the storm has led to firmer action.

The financial meltdown unleashed by the crisis in the market for subprime mortgage-backed securities in the U.S. and, particularly, by the collapse of Lehman Brothers in September, 2007, made clear that there was significant deficit in regulation and supervision of financial activities. Since the Asian crisis, it had become an established principle that financial liberalization must be accompanied by stronger prudential regulation and supervision. This principle was applied in many parts of the developing world, but it was entirely disregarded in the United States, where further liberalization was accompanied by deregulation and weak supervision of financial intermediation. European banking also suffered major problems associated with investments in high risk assets issued in the US, real estate euphoria in a number of countries, and the lending booms in several Central and Eastern European countries, among other factors.

While the massive expansionary monetary policies and interventions to rescue bankrupt financial institutions in the industrial economies contained the hemorrhage, they have only had partial effects in generating

strong recoveries in industrial countries. Steps to re-regulate finance under the leadership of the G20 have been positive but only partial in scope, particularly in relation to the adoption of clear rules that help manage the strong procyclicality of finance. Significant effort in reforming IMF credit lines, increasing the resources available to this institution and making the largest issue of Special Drawing Rights (SDRs) in history have also been important achievements.

However, and crucially, monetary expansion in industrial economies and, particularly, in the U.S. have had major international spillovers, which ignited the so-called "currency wars", making it clear that the global monetary system also need deep reforms. This is an area where reforms have been insignificant so-far. Since 2009, there had been calls by the Chinese Central Bank governor and the UN Commission of Experts on Reforms of the International Monetary and Financial System headed by Joseph E. Stiglitz, among others, for deep reforms of the global reserve system. The currency wars now indicate that the world exchange rate system –or, rather "non-system", as it involves a mixed of all possible exchange rate regimes that has shown limited capacity to correct global imbalances— may also need an overhaul. And in the face of the flood of capital that they have received since mid-2009, many emerging and developing countries are responding by strengthening or re-imposing capital account regulations. These interventions may also have partial effects and also generate international spillovers of their own, indicating that cross-border finance may also require regulations of its own, in fact as part as the global effort to re-regulate finance.

The four elements of global monetary reform –the global reserves and exchange rate systems, capital account regulations and emergency balance of payments financing— are closely interlinked. This is reflected, first of all, in the fact that countries can adjust to variations in net capital inflows through a mix of four mechanisms: letting their exchange rates move (the second mechanism), absorbing such flows through changes in foreign exchange reserves (the first), controlling inflows or outflows (the third) and getting IMF financing (the fourth). The linkages between the four elements were also reflected in the way the post-war monetary system was designed at Bretton Woods, which included a dual gold-dollar standard, together with the principle that exchange rates would be fixed but could be adjusted in the face of fundamental balance of payments disequilibria, the capacity of countries to resort at any time to regulating capital flows, and limited IMF balance of payments financing.

The collapse of the first of these components of the global monetary architecture in the early 1970s gave way to a system in which inconvertible

(fiduciary) dollars are the center of the global reserve system and major currencies fluctuate against each other. More generally, however, IMF members are allowed to adopt any exchange rate regime so long as they "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members", as Article IV of the IMF Agreement reads. The U.S. and the then Managing Director of the IMF tried to add a third leg to the system during the IMF Meetings in Hong Kong in 1997: the principle that capital accounts should be liberalized. They failed, but market pressure and mainstream economic thinking have imposed this principle in practice. So, we now have a global monetary system essentially based on: (i) a fiduciary dollar standard (and secondarily, on competition of different currencies to play the role of reserve currencies); (ii) the freedom of countries to choose whatever exchange rate system they prefer with flexible exchange rates being the dominant mechanism among major currencies; (iii) largely free capital movements; and (iv) IMF financing that has been increasingly small relative to the magnitude of balance of payments crises.

Lastly, the ongoing crisis in peripheral Europe has reminded us, not only that the global financial crisis is far from over, but also that one of the major gaps in the international financial architecture is the lack of a regular institutional framework to manage debt overhangs at the international level—i.e., a debt court for sovereigns similar to those created to manage bankruptcies of firms at the national level, the decisions of which are legally binding.

Comprehensive yet evolutionary reform

The current system is thus proving to be inconsistent with global macroeconomic and financial stability. There is, therefore, a need for comprehensive reform, a fact that each new phase of the crisis has made increasingly clear. What is most interesting: many of the elements of reform can evolve out of some existing arrangements, as has been happening in some areas already (e.g., in the issuance of SDRs, new IMF credit lines, and some capital account regulations), a fact that makes it more feasible. Reform should respond to two major objectives: global macroeconomic and financial stability. It should give priority to crisis prevention, but history also indicates that there is also a significant deficit of good tools for crisis management, and that the two dimensions are clearly interlinked.

A comprehensive reform should be defined in terms of five essential elements that a good international monetary and financial architecture should include: (i) facilitate the consistency of national economic policies of major countries with the stability of the world economy system, and avoid negative macroeconomic spillovers, particularly through exchange rates; (ii) design an international monetary system that contributes to the stability of the international economy and is considered as fair by all parties; (iii) regulate the financial and capital markets in all countries, as well as cross-border transactions, in order to avoid excessive risk accumulation and moderate the pro-cyclical behavior of such flows; (iv) offer emergency financing during crises; and (v) provide adequate debt workout mechanisms at an international level to manage problems of over-indebtedness. The first two of these elements, as well as the fourth, relate to global macroeconomic stability, whereas the third and fifth relate to financial stability. In turn, the first two elements have to do with crisis prevention and resolution, the third with crisis prevention, and the last two with to crisis management. However, this distinction is not clear cut, as latter two may be good for crisis prevention –particularly to avoid a liquidity crunch from turning into a solvency crisis and moral hazard, respectively.

The first of these objectives is clearly incorporated at the onset in the Articles of Agreement of the IMF that state that the first objective of this institution is to provide "the machinery for consultation and collaboration on international monetary problems". However, one of the major deficiencies of current international arrangements has been the tendency of major economies to sidetrack the Fund in major efforts at macroeconomic policy coordination, and to use alternative informal mechanisms –a pattern that may be called "elite multilateralism". This is how the crisis of the early 1970s was managed, leading to the 1971 Smithsonian Agreement, as well as the global imbalances of the 1980s, which were equally dealt with through the 1985 Plaza Agreement and 1987 Louvre Accord. The G20 is the most recent of these fora, although it uses the IMF to assist the country-led, consultative Mutual Assessment Process, a major innovation introduced in the September 2009 Pittsburgh G20 Summit. The best case of a global macroeconomic issue that was at the end dealt with within the IMF was the creation of the SDRs in the 1960s. A more recent exercise, the multilateral surveillance approved in 2006, was at the end insubstantial. The IMF has more recently created a new mechanism of surveillance that can have multilateral implications, under the name of "spillover reports".

Today, the major spillovers are associated with the effects that uncoordinated monetary policies have on exchange rates, and the potential effects of issuing an excess supply of the major global reserve currency. The first relates to the exchange rate system, the second to the global reserve system.

The major problem in the first case is, of course, the possible "manipulation" of currencies by countries, an issue that both the IMF and the G20 have failed to tackle so far, although its definition is incorporated in Article IV (see above) and in the June 2007 decision on bilateral surveillance. But beyond that, it can be said that even a more important problem of the exchange rate system is that it is totally dysfunctional in facilitating stable trade flows and correcting global payments imbalances. A major paradox of the current system is, indeed, that there is no mechanism linking world trade and exchange rate rules. Countries spend years negotiating trade rules, but exchange rate variations can have within days more effects on trade than those painstaking deals. On top of that, exchange rate movements are essentially determined by financial flows, and may have no effects in terms of correcting global imbalances. The exchange rate system seems therefore to have failed to meet three additional objectives also set in the first IMF Article of Agreement: "to facilitate the expansion and balanced growth of international trade", "to promote exchange stability" and to "lessen the degree of disequilibrium in the international balance of payments".

The second spillover, associated with the supply of the major reserve currency, emphasizes the problems faced by the global reserve system: those generated by the use of a national currency, the U.S. dollar, as the major global currency, a problem that is today a revised form of the "Triffin dilemma". This system faces two major additional problems: the asymmetric adjustment it imposes on surplus vs. deficit countries, and the inequities generated by the need that developing countries face to accumulate foreign exchange reserves to manage the strong pro-cyclicality of capital flows. The latter generates, in turn, a "fallacy of composition" that contributes to global imbalances.

The analysis of these interlinked problems indicates that the system should be overhauled. Among the several alternatives on the table, the most logical one is to place the SDRs at the center, in fact fulfilling the expectations created when this system of cooperation was launched in 1969. This system should also be the basis for a mechanism of balance of payments financing, which deepens recent IMF reforms and guarantees that the system is self-financed, in a very similar way to how central banks money creation and financing operates at the national level. In short,

creation of global money should also be the way to finance IMF credit facilities, the fourth leg of global monetary reform.

"Excessive" exchange rate volatility associated with capital flows points to the third leg: capital account regulations. It is useful to recall that a major agreement during the recent crisis was that deregulated financial activities can be a source of major macroeconomic disruptions. The G20 has led a major effort to re-regulate finance, mainly at a national level. However, *cross-border* finance has been left almost entirely out of the agenda, as it did not require any regulation or as it was not part of global finance. A particular twist of language is also involved in analyzing this issue: domestic financial regulations are called by that name, but if they involve cross-border flows, they are called "controls". We would refer to them by their appropriate name:' capital account *regulations*. They could include "best practices" already in place, such as reserve requirements on cross-border inflows, minimum stay periods for incoming capital, and prohibition of certain transactions —e.g., lending in foreign currencies to economic agents that do not have revenues in those currencies. The absence of attention to cross-border flows in ongoing regulatory efforts is, together with lack of clear consensus on how to manage counter-cyclical prudential regulation, a major gap in current efforts at strengthening prudential regulation worldwide.

Finally, the lack of a regular institutional framework to manage debt overhangs at the international level—i.e., a court similar to those created to manage bankruptcies in national economies, the decisions of which are legally binding—is one of the major deficiencies of the current international financial architecture. The only regular institutional mechanism in place is the Paris Club, which deals exclusively with official financing. The system has relied in the past on ad-hoc mechanisms, such as the Baker and Brady Plans of the 1980s and the Heavily Indebted Poor Countries (HIPC) and the Multilateral Debt Relief (MDRI) Initiatives since the mid-1990s and 2005, or on traumatic individual debt renegotiations. The problem with all these mechanisms has been that they generally come too late, after over-indebtedness has had devastating effects on countries. The system is also horizontally inequitable, as it does not treat all debtors or all creditors with uniform rules.

The discussion of the new international financial architecture should solve this problem by creating an international debt court, which would serve both as mediator and, if it fails in that task, as arbitrator of both public and private sector international disputes involving sovereign debt. Privately-run restructuring mechanisms, based on the active use of collective action clauses, are clearly insufficient in this regard. Debtors may

in fact delay using the mechanism to avoid antagonizing creditors. It is also unlikely to generate a uniform treatment of creditors and fails to treat official and private lending with a unique set of rules, therefore maintaining the horizontal inequalities of the current system.

Building an inclusive international financial architecture

Reform of substantive issues affecting the global monetary and financial system has to be matched by the design of appropriate governance structures. Good but incomplete steps have been taken in this area. The most important have been the decision to extend membership of global financial regulatory institutions to the G20 members, and the inclusion of major developing countries in the G20 itself, which self-designated itself in the September 2009 meeting in Pittsburgh as "the premier forum for our international economic cooperation". But such "elite multilateralism" also faces a major problem, as ad-hoc self-appointed bodies cannot replace representative institutions in a well-structured international financial architecture.

The reforms of "voice and representation" for developing countries in the Bretton Woods Institutions (BWIs) predate the creation of the G20 at the leaders' level, and have continued to take place partly on a parallel track. In April 2008, a modest agreement was adopted on reforming quotas and votes in the IMF Board, which entailed a redistribution of the quotas and a tripling of the basic votes to increase the voting rights of developing countries by 2.7% as a whole. In October 2010, just before the meeting of Heads of State in Seoul, the Ministers of the G20 agreed on, and the IMF Board approved in November 2010 a more ambitious reform of IMF governance. This reform includes doubling the quotas, revising the allocation of quotas and voting power of developing countries while protecting those of the poorest countries, reducing by two the European representatives in the IMF Board and electing all of its members. However, the increase in the quotas (3.9 percentage points) and voting power (5.3 points) of developing and transition economies was less than expected by these countries, and the large gains by some of them (China, Republic of Korea, Brazil, India, Mexico and Turkey, in that order), which adds up 7.3 and 6.7 percentage points in terms of quota and voting power, respectively, came partly at the expense of other developing countries.

To these we must add other important proposal made on various occasions, including by the 2009 Commission for IMF Governance Reform headed by Trevor Manuel: a reduction in the threshold of votes needed to approve important IMF reforms from the current 85% to, for example,

70-75%; the creation of a Council of Ministers with effective powers to adopt the most important political decisions, thus replacing the International Monetary and Financial Committee; and a clear redefinition of the relations between this Council, the Board and the administration.

For its part, in the spring 2010 meetings, the World Bank approved a transfer of 3.13% of voting power from the developed economies to the developing and transition economies, which will now hold 47.19% of voting power and have received a promise that they will reach parity in the near future. The increases were mainly concentrated in middle-income countries, especially in Asia, which were under-represented, while low-income countries saw limited change. This change was achieved through an ad-hoc capital increase, not through the agreement on a formula for dynamic revision of capital based on clear principles, including the Bank's development mission. There was agreement that this would be done by 2015.

The G20 has also agreed that the senior management of these organizations should be chosen on the basis of transparent and open processes, based on the merit of the candidates, and regardless of nationality. It would also be useful for the personnel of these institutions to be more diverse, not just in terms of nationality but also in terms of education and professional experience, as well as gender.

The broader issues on global financial governance relate, however, to "elite multilateralism" —i.e., to the G20 itself. The creation of this G at a leaders' level was, of course, a step forward compared to the G7, in terms of representation of developing countries. But this solution also created problems because of the ad-hoc nature of the cooperation mechanism adopted, including the way in which the membership was defined, which implies the exclusion of some large countries (Nigeria is the case that most clearly stands out) and (once again) the overrepresentation of Western Europe.

This preference for "Gs" over representative international institutions reflects the challenge of overcoming the tension between representativeness and the legitimacy associated with it, on the one hand, and existing power structures, on the other. This issue is sometimes expressed as the tension between inclusiveness and effectiveness, but this is clearly a wrong way to pose it, as national democracies have shown that representative institutions can be effective. It reflects rather the revealed preference by industrial countries for "Gs" over which they can exercise greater influence.

Therefore, although Gs can play an important role in placing new issues on the agenda and facilitating consensus among major powers, no structure of governance can generate legitimacy as long as decision-making processes are not inclusive. For this reason, the G20 should be seen as a transition to a more representative, and thereby legitimate, mechanism of international economic cooperation.

One such mechanism would be the Global Economic Coordination Council proposed by the previously mentioned UN Commission of Experts on Reforms of the International Monetary and Financial System, which is in turn part of a long history of proposals to create a UN "Economic Security Council". According to this proposal, the Coordination Council would be set in the framework of the UN *system*, to which the BWIs belong and the WTO would become a member. It would be formed on the basis of constituencies elected through weighted votes, thus following the model by which the Boards of the BWIs are made up, though with formulas for representation that overcome the problems that those institutions face.

Aside from this potential mechanism, the United Nations can play an important role in global economic governance. It has proven to be a very effective mechanism for consensus building (notably, in the realm of finance, the Monterrey Consensus), and in the generation of new ideas and a framework for international cooperation (in particular, the Millennium Development Goals), though its effectiveness has been limited by the tendency to limit its role in the implementation of these agreements and to severely limit the resources it manages. In retrospect, some of the analytical contributions of the UN Secretariat on strict global financial issues (by UN-DESA, UNCTAD and ECLAC, in particular) have been sounder than those of the Bretton Woods Institutions. The UN has also made important contributions to these debates through the convening of high level technical groups, such as the Zedillo and Stiglitz commissions.

Finally, in all of the areas of reform, the global architecture should rely more broadly on regional institutions. Indeed, in a heterogeneous international community, the creation of *networks* of global, regional and national institutions will provide a better system of governance than arrangements based on single global organizations. This is based on old federalist principles: regional and sub-regional institutions give stronger voice and a sense of ownership to smaller countries. These institutions are, therefore, more likely to respond to their demands. This has already been recognized in some areas, such as the system of multilateral development banks, where the World Bank is complemented by regional development banks and, in some parts of the world, by sub-regional (in particular, in

Latin America and the Caribbean) and inter-regional banks (the Islamic Development Bank).

The creation of such an institutional network is particularly urgent in the monetary arena, where the IMF should make more active use of regional institutions, such as the Chiang Mai Initiative and the Latin American Reserve Fund, and support their creation in other parts of the developing world. Indeed, the IMF of the future should be designed as the apex of a *network* of regional reserve funds. Aside from its benefits in terms of participation by all countries, this design would be much better to promote macroeconomic policy dialogue and crisis prevention and management at the world level. A similar institutional design could be adopted for prudential regulation and supervision, overcoming again the tendency to manage prudential regulation through elite multilateralism –in this case, the Financial Stability Board.

REGIONAL AND GLOBAL LIQUIDITY ARRANGEMENTS FOR A MORE DEMOCRATIC AND HUMAN WORLD

THE POTENTIAL OF SDRS

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The new phase of the global crisis reinforces the urgent need for a different world monetary system. Without substantial reforms not only the possibilities of recovery are blocked but the deleterious forces and behaviors that led to the crisis will be strengthened. The deepening of that type of logic among the world's commanding heights could open a long period of degradation of civilization by exacerbating the existing trends for more wars, conflicts, exclusion and social polarization, waste, and environmental crisis.

The US dollar's monopoly of international liquidity helps to sustain global imbalances and, combined with financial deregulation, forces all non-hard-currency-issuer countries to accumulate reserves in a defensive way – thus nourishing the same dollar monopoly and sacrificing resources of productive investment, job creation, and wealth and welfare generation.

The reinforcement of asymmetric macro and microeconomic responses in an overproduction scenario, besides the unfair anti-competitive outcome, further nuances the climate of international co-operation and fosters pressures for trade wars (under the form of currency wars, for example, with further parity misalignments). The massive bailouts deployed by certain governments in favor of huge financial institutions contrasts with the technical, legal and even self-imposed restrictions created by the majority of countries. In the face of reduced investment opportunities and with growing concerns clouding confidence on the structural situation, those resources do not result in more credit, more jobs

or more capabilities to create wealth, but in a metastasis of infectious assets and business practices and the multiplication of bubbles.

The deployment of these processes has triggered ferocious vectors that affect the basic mechanisms of market functioning. On one hand, crucial relative prices become structurally decoupled from the evolution of, for instance, reproduction costs or seasonal scarcities. In combination with the currency misalignment, the misleading effects on enterprises' and countries' investment perspectives and specialization could result in large and painful future corrections with no guarantee of viable and sustainable allocations in the aftermath. On the other hand, the magnitude and capillarity of financial transnationalization opens new sources of vulnerability due to moral hazard, lender of last resort, "creative accounting" and pervasive deregulation issues. The risks for financial and macroeconomic stability could compromise peace and democracy.

This note proposes that in order to foster the construction of global public goods and a climate of co-operation, the global liquidity arrangements should incorporate the yearly issuance of special drawing rights (SDRs), without any austerity conditionality (except, perhaps, some "everything but weapons" condition) and at zero financial cost. This is a technically viable option – should the political will be found – and one that would provide additional resources that would support policy space for national stimuli and reduction of debt acquisition.

The issuance of SDRs would also open up new perspectives for deploying South-South cooperation initiatives. For example, with small changes in the IMF's normative procedures, regional stabilization funds and swap mechanisms could be supported with part of the members' SDR quota without the need to convert these SDRs into hard currencies.

Complementarily, the capabilities of such funds and swap mechanisms could be improved with a new repertoire of reserve assets like innovative schemes of natural resources management, as in the Ecuadorean proposal of "keeping the oil under the soil" for the Sarayacu and Yasuní regions. With such additional oxygen, it would be possible to reallocate national central bank reserves to define a regional system of hard currency cushions and the derived portfolio of regional reserve alternatives.

Moreover, the issuance of regional equivalents of SDRs (like the Latin American SUCRE) would be a complementary means of payments. Ideally, the "global" SDRs would be institutionally defined as part of a lender of last resort scheme for these regional arrangements. In turn, the regional arrangements could include also, *inter alia*:

• Financial safety networks like that proposed for Latin America, directly connecting the national central banks through the electronic systems of payments, making available a technological platform for new services like a matrix of multilateral swap mechanisms among central banks (a departure from the Chiang Mai Initiative);

• The deployment of regionally-focused markets of liquidity (both for public and private agents) in order to eliminate the stigma still pending upon some open market operations and fiscal debt issuances in the South and to recycle the massive amounts of regional savings which usually fly with low nominal returns and high risks towards financial markets that are the epicenter of the structural insolvency crisis;

• The creation of new emergency credit facilities as insurance for fiscal and balance-of payments needs. With the adequate harmonization of prudential regulation in banking as well as in the financial and exchange markets, these regional arrangements could have enough power and credibility to allow for a gradual convergence towards fixed but adjustable exchange rate systems in line with the long-term equilibrium of the trade balance, isolating the effects of capital account volatility. Several phases of convergence should be negotiated according to the economic and political conditions of each region, including dynamic macroeconomic policy co-ordination, potentially evolving into a system akin to the old European Monetary System.

Even with the same stochastic dynamic optimal control model and the same parameters of risk aversion and environmental uncertainty, the optimal accumulation of international reserves for each country must be reduced with these types of regional arrangements, freeing resources for productive investment and addressing goals of long-term regional, environmental and social sustainability through a new kind of development bank like the *Banco del Sur* Initiative for UNASUR (South American Union of Nations), with alternative priorities (regional sovereignty in food, energy, health care, science and technology, physical connectivity, financing of the heterogeneous popular economy, etc.) and new practices, including the use of domestic and regional currencies.

For the Northern countries, an allocation of SDRs is less important, since they can usually issue their own fully-convertible hard currency. In most cases, restrictions for macroeconomic and financial sovereignty are imposed by Northern countries from within rather than from without. New contents in the European construction in prioritizing full employment policies could complete a different scenario of multi-polar, more democratic global governance.

Issuance of SDRs could open new types of North-South relationships, too, e.g. the donation of the North's quota of SDRs in order to fulfill the promise of increasing official development assistance to 0.7 percent of GDP. Few technical and normative changes are required to achieve this without financial cost, inflationary pressures or budgetary disputes (no country in the North has used the SDRs to finance the deficit). This would free funds in the order of US$ 150-200 billion per year that could be used for addressing the most pressing challenges, including support during humanitarian emergencies and natural disasters; achievement of the Millennium Development Goals such as the eradication of extreme poverty and hunger; and measures to counter environmental crises and mitigate climate change.

In sum, this alternative scheme that combines regional and global liquidity arrangements with the support of yearly issuances of new SDRs will open a new horizon of stability. But this also raises the prospect that it will be politically opposed by very powerful speculative interests that are currently profiting from the deepening of the crisis. Thus, several additional regulatory measures must be taken in order to make these efforts towards a New Global Financial Architecture politically viable. Among them, I would suggest:

• In order to immediately block the restoration of the blackmailing powers of the Old Financial Architecture (the IMF has given much more credit since autumn 2008 than in all previous decades), we need to channel all new resources that have been already promised or given to the IMF through a new window. This new window would operate in emergency terms (cheap and agile), without the neoliberal adjustment conditionality and with an alternative directory that would reflect a more democratic representation of the regions. A precedent to study in this regard is the Global Environment Facility within the World Bank.

• Provide developing countries with real capabilities for deploying counter-cyclical policies. It is urgent, in this regard, to create fiscal policy space through measures such as immediate external debt moratoria as proposed by UNCTAD and the generalization of debt auditing processes (such as done in Ecuador) and the introduction of an International Debt Arbitrage Tribunal.

• Universally ban short-selling and other speculative mechanisms like specific credit default swaps, especially in the global food provision chain (seeds, products, inputs, etc. both in spot and future markets).

• Implement a universal definition of efficient and transparent capital regulations and raise a global, though nationally-collected, Financial Transaction Tax.

THE REFORM OF THE INTERNATIONAL MONETARY SYSTEM

OR HOW TO HURRY SLOWLY BUT SURELY

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After Seoul there seems to be a will to attempt to reform the International Monetary System and it is high time to address this issue. The undervaluation of the Chinese renminbi is only very slowly fading away and this as a result poisons the relationships between the USA & China. But the crisis of payments is not simply limited to this matter and everywhere the imbalances multiply looming ahead thus justifying the many endeavours to reform the system deeply. Yet the odds are slim to see a new Bretton Woods born from the Seoul travails and this for three reasons.

At first because the last meeting of the G20 has confirmed all the ambiguity of the main actors' positions: "a truce is taking place on the currencies war front" so it was pretended but in reality nothing has been solved. Let us not expatiate on the rule of the + - 4% of GDP of the current balance that was only an American decoy meant necessarily to hurt the great exporting nations. In fact at the last minute the Americans backed out dropping their charge that the renminbi exchange rate was being tampered with, a statement that would have lead to a charge against China being filed with the WTO. As a trade off it looks as if the Middle Empire has renewed its pledge to push for a re-evaluation of the renminbi but at a pace that it would choose unilaterally without excluding that such a move could be a reminder of Mao 's long march.

A second event has entered the debate namely the new course taken by the American monetary policy embodied by the recent instalment of the second quantitative easing.

The US Federal administration is about to inject $ 600 billion by issuing treasury bonds bought back by the Fed Reserve while no one has the

slightest clue where these bonds are going to land. If, as cannot be excluded, instead of lowering the long term rates to boost consumption and investments, they were to fuel international speculation in favouring the group of assets that we know (gold, shares, raw materials, food supplies, etc) then the business of the IMF reform would be in dire straights. This enterprise would risk colliding with a massive arbitration against the dollar that might muddle everything, particularly for the Euro which would be viewed as the last recourse to the mis-alignment of the dollar-renminbi rate. Even worse the loss of control by the American monetary policy would entail a run on the dollar, undermining its credibility as the central linchpin of the IMS. Yet nobody can say whether this situation might lead to a return of inflation, which Americans are quietly wishing for without loudly voicing it in order to ease their debt, or it would encourage the present pregnant trend towards deflation. Besides we cannot rule out that the USA through a massive use of the money printing press have signalled to China that if necessary they had a kind of "nuclear deterrent force" to notch the yuan up while they themselves are pushing the dollar exchange rate down through their own monetary policy. Perhaps, as Milton Friedman loved to say, one opportunity here to remind others that the exchange policy is like tango a dance demanding two partners.

Thirdly there is another reason to cast away some illusions on the immediate plasticity of the IMS for wherever we look around we cannot make out the new founding principle able to attract a unanimous adhesion to the justification of a new Bretton Woods.

One way or another returning to the concept of "target zones" of the nature of the 1985 Pla za accords precludes a strong consensus to define the variation brackets and the central rates. Today there are too many parties involved and gaping chasms do remain between the estimates of the currencies over/under evaluation. Is it possible to move towards the special drawing rights being substituted to the dollar as an international currency? This hackneyed idea that was reintroduced by China herself, on the condition of creating a special account with the IMF, is not completely an uninteresting one. Besides the reform of the IFM governance, as accepted in Seoul, takes effect very appropriately on time. However a strong objection prevails, for as illustrated by the long history of the Pound Sterling & the Dollar, it seems hard to conceive an international currency since it can only prevail and succeed through being used and one that would not be adopted by the international markets seems difficult to be thought of.

The day has yet not come when exports and imports will be invoiced in SDR. Yet, it is rather on an increased volume of invoices billed in yuan that

the Chinese authorities are betting on which on top of the dollar outstanding privilege might add one day that of the Yuan. One way or another finally it will be of the utmost importance to succeed in separating sometime the international currency from its own nationality, this step could even become one of the compulsory moves for the very start of the reform since it appears now so obviously that making a national currency the central linchpin of the IMS will lead sooner or later to the loss of control of the liquidity.

As for the recent avant-garde idea of Fred Bergsten and Daniel Gros to counterweigh the Chinese buying of American Treasuries by the American purchasing of Chinese financial assets in order to establish some virtuous reciprocity it clashes for the moment with a nullifying obstacle namely the strict control of the flows of capital into China. Furthermore recently even the proposal made by R. Zoellik, the President of the World Bank, to return to the gold standard—a fifty year old comeback into the limelight—has found a new life although the unstoppable bubble of the gold price would render its implementation hardly possible. Finally perhaps let us not forget to mention the approach suggested a long time ago to us by Robert Triffin after his reading one of our articles,[23] the path leading to a multicurrency system called monetary "oligocentrism" ie one composed of a small number from the Greek "oligos" of international currencies (three or four with of course tomorrow the renminbi) which would fluctuate each one versus the others and whose weighed basket would be the cornerstone of the whole IMF while nonetheless the tricky problem of defining the central linchpin would remain.

As can be seen the formulas do exist and others can probably be conceived. Each one in turn has to be carefully weighed and examined, not with keeping an eye on the past, but on the contrary with focusing on the present difficulties without brushing aside the novelties or associations that might be imposed by China's march towards power, by the coming of age of emerging nations, by the American condition and eventually even the shaky euro situation. In short the work that lies ahead of us is enormous and a genuine launching window for an immediate reform of the IMF does not exist yet without at first a thorough effort of clarification. Does this mean we have to be discouraged and stop acting? This would be the worst possible reaction for on the contrary we must actively prepare the grounds

23. Henri Bourguinat(1981) "The European monetary system and the Dollar: diversification versus stability".Europe and the world-wide Disequilibrium, J.R Sargent ed Sijthoff et Noordhoff. Voir aussi du même auteur: *Finance Internationale, PUF (1995) et Dalloz (2008)*

for a new Bretton Woods but in doing so within a reasonable span of time (two to three years) heading for the First World Conference of the 21st century starting with a precise agenda and a wealth of renewed proposals that would all have been studied in depth.

A NOTE ON THE INTERNATIONAL MONETARY PROBLEM

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The problem with the debate on international macro-economic reform is that there are too many solutions in search of a problem. Quite apart from the fact that tinkering around with nominal exchange rates doesn't solve anything real, sustainable solutions can only be found when we have separated the real problems from those that merely sell well on political soap boxes.

In the field of international money there are three main problems to be solved.

The first is that every country bar one, is well incentivized to develop policies that are right and good for itself. It is with some irony that many anglo-saxon friends believe the one is China given the Chinese and Indian origins of what the Portuguese later called the "Mandarins". The one exception is the issuer of the world's reserve currency.

This country does not have a budget constraint like others. Goods and services can be paid for by IOUs never claimed upon. The US is the provider of the world's reserve currency today and the last time national spending was less than nation income was thirty years ago. Issuers of paper currencies held as reserves are prone to excessive debt-financed consumption that ultimately sinks the standard, drowning everyone else on it. Trying to constrain the hegemon, often in its own long-run interests, is the Sysphusian goal of the rest of the world.

The second problem is that in the natural state of affairs, is a single reserve currency. This is because there are strong network effects. If one asset is known to offer liquidity and value in a crisis, it becomes a self-fulfilling prophecy that draws liquidity and value from all other assets. This concentration of world reserves into one asset, vulnerable to being

devalued, is risky for holders of the reserve assets, as the Chinese are observing today and as President De Gaul observed in 1970. Without sufficient vigilance by the monetary authorities of the reserve issuer, the concentration of international savings and its potential is able to fan the flames of an unsustainable boom in the issuing currency with potentially highly adverse consequences—as we have seen.

If half the world wants to spend and the other half wants to save, perhaps because they have a commodity windfall like Russia, Brazil and Saudi Arabia, or they are already investing a large amount of GDP or have an overhang from some past over-investment, as in China, where 50% of GDP is invested, or Japan and Korea, and these countries invest these savings internationally in countries that want to spend, is this not a measure of an international monetary system working well? The problem of global imbalances is not that imbalances exist, but that there is a concentration of spending and saving that is aggravated by a single reserve currency.

John Maynard Keynes was exercised by another problem, which is what would happen if the issuer of the world reserve currency was a surplus country as in 1940s America. This would be deflationary, but we have been saved that particular misfortune today. It is worth mentioning, however, as it was the background to his ideas around bancor, that are being re-floated today.

A solution to these real problems is often weighed down by genuine concerns over other legitimate problems that are best solved through other means than international monetary reform. These include the scourge of world poverty, the unconvertibility of some developing country currencies and the human and social consequences of adjusting to lost competitiveness. But if reform to the international monetary system appears artificial and "soft" they will not convince those charged with protecting their country's financial balances and will be still born. The dustbin of history is choc-a-bloc with utopian currency ideas.

The solution would be for the IMF, or another treaty-based organization to issue a new currency, but not a basket currency or some grown up unit of account, not something handed out free to those with unconvertible currencies or anyone else, but something hard. The guardians of this hard currency would have as a primary objective to ensure that it would never systematically depreciate versus any of today's major currencies. It would not be backed by any paper currency, but by a basket of real assets, independently certified and income-producing, limited to world resources that are consumed by unsustainable economic expansion. Imagine a basket of sustainable forests and water resources. Reserve managers could be

charged with ensuring that investments in these assets were also globally diversified. By being convertible, marketable and with a remit to be strong, this currency would be an attractive store of value. By investing in income producing real assets it would be liquid and by being internationally diversified, we address the problems associated with concentration. The accumulation of reserve assets would not be financing an unsustainable asset-price boom in a narrow set of countries, or an income-sapping investment by others, but an investment in all of our futures.

5. STRUCTURAL ISSUES

PRIORITIES FOR THE G20

CLIMATE CHANGE

Nicholas STERN – *LSE, London*

GLOBAL IMBALANCES

Yu YONGDING – *IWEP, Beijing*

PRIORITIES OF THE G20
CLIMATE CHANGE

Nicholas Stern
LSE

At the national level 2010 was a mixed year for progress on climate change: many developed countries hesitated, as in some of Europe, or stepped back as in the USA; on the other hand many developing countries moved forward as in China's 12th five-year plan, India's action on renewables and energy efficiency, and Brazil and Indonesia on forestry. At the international level, after the disappointment and acrimony of the UNFCCC meeting in Copenhagen in December 2009, the progress was largely positive; the consolidation of the Copenhagen Accord in terms of emissions commitments for 2020, the agreements in Nagoya in October at the Convention on Biodiversity and the agreement in Cancun at the UNFCCC (COP16) on climate change. The G20 Seoul summit in November was broadly positive, including, its welcoming of the work of the UN Secretary-General's advisory group on climate change financing. Business commitments have continued to move forward with rapid technical progress, investment in renewables, and further pressure on the political process to create a stronger and clearer policy environment, as in the G20 Business Summit in Seoul.

There is some momentum and a modest international platform for further progress in 2011, building to COP17 in Durban, South Africa at the end of the year. But, for progress to be major, strong leadership under the French Presidency of the G20 is required. For developed countries, whose attention has been diverted by the financial and economic crises this must include helping to overcome wavering commitment. For developing countries, it must include fostering the recognition that an alleged trade-off between reducing emissions and overcoming poverty is largely false. Both of these can be achieved if we focus on the understanding of three key issues; recognition of the necessary scale of adjustment; the attraction of

the new energy-industrial revolution that will be necessary; and the complementarity between action on climate change and resolving the international macro challenges of this coming decade.

1) World discussions have accepted the '2°C target', specifically understood as around a 50/50 chance of holding average world temperature increases relative to the mid 19th century to 2°C. But they have not faced clearly and honestly the quantitative reductions which are required. We must as a world, to achieve this target, reduce global emissions, which are currently around 48 billion tonnes of carbon-dioxide equivalent in 2010, to around 44 in 2020, well below 35 in 2030, and well below 20 in 2050: in other words from around 7 tonnes per capita now to around 2 in 2050. Or with a moderately growing world economy (say multiplying by a factor of 3 in 40 years) cutting emissions per unit of output by a factor of between 7 and 8. This means a new industrial revolution starting now. World leaders have not yet recognised fully these implications of the 2°C target. And they probably have not yet fully understood the magnitude of the risks of missing the target in terms of the significant probabilities of 3, 4 or 5°C by the end of the century, temperature increases (certainly in the case of 4 or 5°C) which would transform where many hundreds of millions can live. Without clear understanding of the necessary scale of adjustment, progress may be dangerously slowed. The G20 is the right forum for this clarity on the necessary economic and industrial transformation.

2) The politics, however, of embracing the necessary scale becomes much more attractive if we recognise that the transition to a low-carbon economy will be full of creativity, innovation and growth. It is the growth story. This is a narrative which must be set out, strongly and clearly at the most senior level. Past economic transformations, from the mechanisation of textile production in the 18th century, to steam and railways in the 19th century, to information technology in the 20th, have brought 2 or 3 decades of dynamic growth, with investment flowing to the pioneers. This technological transformation, with its necessity rooted in the huge market failure of unpriced greenhouse gas emissions, requires strong national and international policy.

Korea and China have seen this clearly. Indeed, in many ways, the most significant economic event of 2010 was the announcement of the outline of the 12th five-year plan for China (2011 – 2015). The two key themes are (a) the advance of the Chinese consumer and (b) the transition to a low-carbon economy. Seven sectors the ('magic seven') are targeted to grow from 3% to 15% of the economy by 2020 on top of an overall 8% growth rate. The industries are in large measure 'green tech' and the investment

will be phenomenal. Those countries and regions, we hope including Europe, that partner with China will see immense advantages. If Europe and East Asia move strongly, the external reality for the United States could change within a decade, in terms of damaging prospects for dirty exports and being left behind technologically. This could, in turn, intensify pressures for change in the internal politics of the USA. The OECD in Paris and the Global Green Growth Institute in Korea will be leaders in the analysis of this story. So too should be the IFIs. Europe has much to gain by strengthening its commitment from 20% to 30% reductions (1990-2020) and promoting technological collaboration with East Asia. It should not be put off by the siren calls of narrow short-term vested interests, and should embrace the more dynamic growth story. The green race has begun and the pioneers will have great advantages.

3) The big shorter-term international macro challenges of the next few years and this decade, must be examined in the context of this medium and longer-term story of the next industrial revolution and the transition to low-carbon growth. In this decade we must handle four related international macro issues: (i) major world savings and investment imbalances manifesting themselves in trade imbalances, (ii) very large deficits and debts in the public finances of key countries (iii) fragile growth, particularly in the richer countries and (iv) unfinished business in financial and capital market reform. All of these will be easier to handle, not more difficult, if we set them in the context of the two profound structural changes of the next 2 or 3 decades: the transition to the low-carbon economy; and the re-drawing of the international division of labour—the movement of low-cost manufacturing out of the rich countries was just a beginning.

The G20 is surely the place where these shorter-term macro challenges can and must be integrated with longer-term structural change. We damage both the shorter and longer—term if we separate them out. In this case the strong investment in low-carbon infrastructure and new technologies should be at the heart of the economic recovery in the rich world and of the structure of growth in the developing world.

If there is leadership in the G20 on the three key issues identified at the start of this note, then the creation of the necessary coalitions to tackle the challenges of (a) international macro-management, (b) overcoming poverty and promoting international development and (c) managing climate change, will be much more likely. The G20 is the place where the integration of action on these challenges can and must be put together. We damage the prospects for action if we separate our responses to these challenges. In this context key areas for action in 2011 are taking forward

the recommendations of the UN Secretary General's advisory group on climate finance and implementing the Seoul development consensus and action plan.

We must simultaneously foster local and national action and collaborate to create an international agreement on climate change. There is no contradiction in this sense between bottom-up and top-down. On the contrary they support each other. And we need not be excessively formal in the notion of a 'binding agreement'. The key is confidence in where other countries are going, so that in domestic politics people feel part of a bigger story and in business, investors see growing markets for the new technologies and serious risk in the old high-carbon methods. Understanding the economies and policies of other countries is of fundamental importance. China's 12th five-year plan is a good place to start. It is a much clearer commitment to a low-carbon future, essentially a contract between China's government and its own people, than, say, Canada's signature on the supposedly 'binding' Kyoto international agreement.

GLOBAL IMBALANCES

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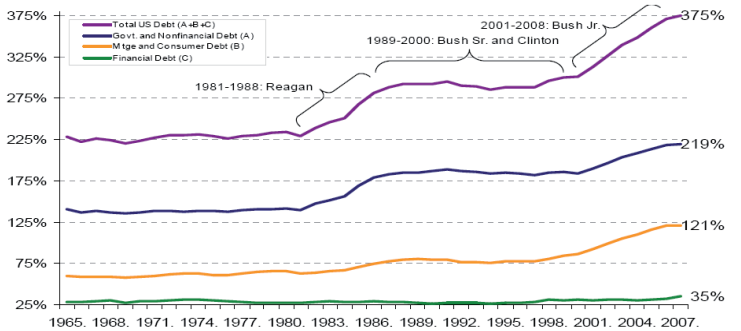
Global recovery is underway. But the prospects of the global economy are not encouraging. First, in the long-term run, the potential growth rate of developed economies will be low, due to a slower growth rate of working age-population and the likely stagnant in labor productivity. Second, fiscal positions of almost all developed countries are worsening rapidly. Now total global debt stands at 41 trillion US dollar, a 24 percent rise from 33 trillion US dollar in 2009. These two facts imply that a global sovereign debt crisis is looming large in the future.

Before the subprime crisis struck in 2007, most economists would agree that global imbalances were the most important threat to global growth. It was commonly theorized that the rise of the net foreign debt-to-GDP ratio (NIIP/GDP ratio) of the US, as a result of the accumulation of current account deficits, would lead to a sudden stop of capital inflows, which in turn would lead to a fall in the dollar and a rise in the interest rates, and hence a crisis of the US economy. However, the scenario failed to materialize. Instead of an international balance payments crisis, the subprime crisis broke out. Why did most economists fail to predict the economic dynamics that actually led to the crisis correctly? The reason is that most economists failed to pay enough attention to the rapid increase in total debt and all its major components, and only narrowly focused on just one component of total debt-- foreign debt and the change in the foreign debt –current account deficit. Foreign debt is a result of deficiency of domestic funds for the finance of total debt. It should not occupy a too special attention in comparison with other forms of indebtedness. In fact, while the net foreign debt-to-GDP ratio was 24 percent in 2007, the magnitudes of other major debts were way larger (Figure 1) .

Figure 1: Total US Debt (% of GDP)



ource: Sterling Stamos analysis; Federal Reserve

In the following discussion we define Total debt = Household debt +Public debt + Business debt. Here financial debt is excluded from total debt to prevent double

In Q3 of 2008, the US total debt-to-GDP ratio has surpassed 358 percent. More specifically, the three components of total debt are mortgage and consumer debt, government debt, and non-financial corporate debt. Debt must be financed. (See appendix)

For any debt positions such as foreign debt, mortgage debt, public debt and business debt, there are problems of sustainability, individually. The sustainability of debt means not only total debt but also each component can be financed continuously. While different debts have different natures, all debts and their finance are interconnected. Troubles in any component of total debt will impact on the other components. For example, the subprime crisis has changed the dynamics of America's current account deficit, leading to a temporary improvement in the account. The public sector leveraging in 2009 aimed at preventing further slowdown of the economy caused by the collapse of the mortgage debt market has led to the rapid worsening of America's public debt position.

It can be seen that the net foreign debt is the difference between US total debt and US total assets (plus equity). Correspondingly, American current account deficit is equivalent to the deficiency of funds for financing US household debt, government debt and corporate debt.

Hence, the problem of global imbalances, which is characterized by the US current account deficit vis-à-vis current account surplus of the rest of the world, is just part of the problem of the funding deficiency of US total debt. The funding deficiency can be divided into four interconnected

components, which deserve equal attention: *funding deficiency of households*, *funding deficiency of the government*, *funding deficiency of nonfinancial corporate* and *funding deficiency of a country*. In a closed economy, the funding deficiency of one or two sectors must be supplemented by other one or two sectors with funding surplus. In an open economy, foreign funds can flow in to make up the funding deficiency of the country.

When the sustainability of US current account deficit is discussed, the focus is on the sustainable level of the US net foreign debt-to-GDP ratio. Though it is easy to decide the steady state of the net foreign debt-to-GDP ratio under given assumptions, it is very hard to decide at what level the net foreign debt-to-GDP ratio will become unsustainable. The net foreign debt-to-GDP ratio is not a good measurement of the sustainability of US current account deficit, because, for foreign creditors, the most important and direct concern is the safety of and returns on the particular US assets they have invested in, rather than the repayment ability of the country as a whole. The reason why the expected crisis caused by global imbalances failed to materialize is that, despite the high net foreign debt-to-GDP ratio, foreign demand for US financial assets, especially US government securities was still very strong. For example, for Chinese investors (the Central Bank), the main concern is with the safety of and return on US government securities. As long as the US dollar will not fall significantly, the worsening of America's external position will not become a major concern for foreign investors. With hindsight, economists should have paid more attention to the sustainability of US domestic debt, especially mortgage debt. The mistake can be seen more clearly, if we notice that the mortgage and consumer debt-to-GDP ratio in 2007 was more than 83 percent, compared with the 24 percent of the net foreign debt-to-GDP ratio. The break out of the subprime crisis and its aftermath show that overextension of mortgage debt relative to incomes of borrowers (NINJA) made US mortgage and consumer debt unsustainable. As prices of MBS and CDO fell dramatically, mortgage debts were unable to roll-over, and a vicious cycle set in. The deleveraging by financial institutions made the funding deficiency worse. Without government intervention, interest rates on mortgages and other financial assets would rise dramatically, the US dollar probably would fall, and defaults would be prevalent, until a new equilibrium was found. The global financial crisis was caused by over-indebtedness. Any long-term and fundamental solution must deal with the over-indebtedness issue. However, to bring total debt down to a sustainable position, high costs must be paid. Mortgage and consumer debt can be paid down by households with their savings or by default of borrowers. In the former

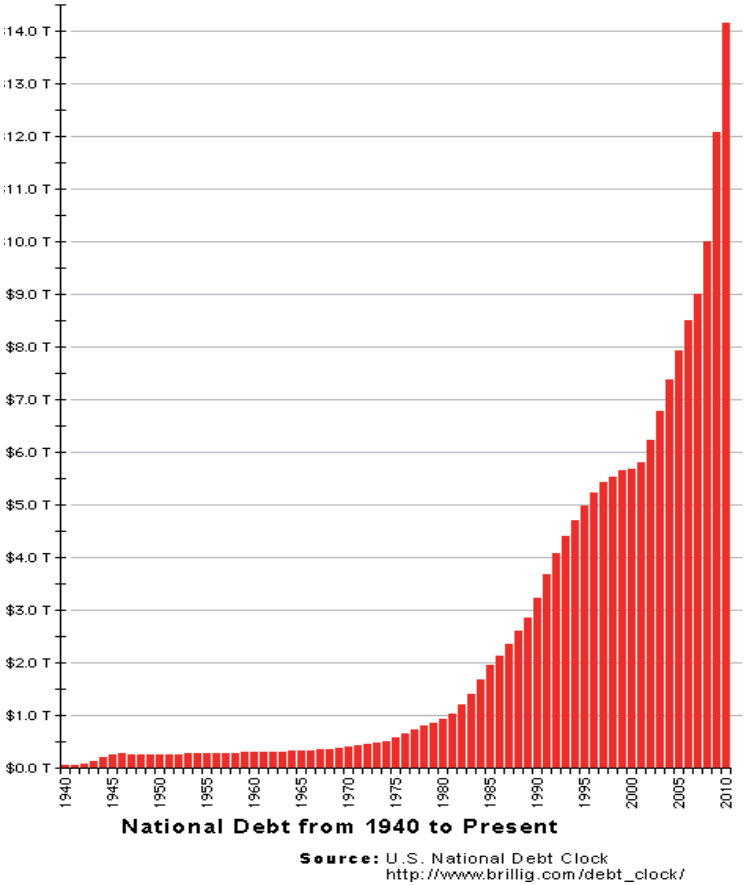
case, more savings (less consumption) may lead to a fall in effective demand and hence a slowdown of economic growth (a rise in unemployment). In the latter case, the creditors would incur huge losses and the economic may fall into a deeper recession. The US government has chosen a politically easier solution. By schemes such as TALF, TARP and QE1, prices of "toxic assets" were artificially prompted up. In other words, funds escaped from the mortgage and consumer debt market were offset by funds pumping in by the government. Private creditors were replaced by the government and risks were shifted from private creditors into tax payers in general. The issue of fairness aside, the government intervention in the mortgage and consumer debt has led to a dramatic increase in public debt. Where will funds come from to finance the increased public debt? There are three possible sources: *funds released from the mortgage and consumer debt market*, *new domestic funds resulted from higher household savings,* and *foreign funds*. The rapid increase in the supply of public debt will become a serious threat to the sustainability of public, unless household savings can increase correspondingly. Now while the balance of household debt has been restored at a knife edge, the sustainability of public debt is becoming a new flash point of global financial instability. The QE II is outright money printing and cannot be regarded as normal open market operations. The launch of the QEII shows that financial markets are no longer able to provide funds—loanable funds to finance US government budget deficit. QEII is an action of desperation.

By the end of 2010, US public debt is above 14 trillion USD (Figure 2). The public debt-to-GDP ratio is more than 90 percent and it is forecasted that by the end of 2020, interest payment on government debt will be more than 30 percent of government revenues. The issue of sustainability of US public debt seems a more serious problem than that of US current account deficit.

If the US private sector is not in a position to provide surplus funds to satisfy the need for financing public debt, the only possible source of finance is foreign funds. However, this means that the US must tolerate current account deficit. Otherwise, virtually there will be no way for the US to get enough funds to prevent a crash in the public debt market. Unfortunately, the European Sovereign Debt Crisis is far from over. Only feasible source of funds is emerging economies, especially China and oil producing countries. If foreign funds stop flowing into the US government bond market, and/or other capital markets to release domestic funds to supplement the government bond market, a public debt crisis may be inevitable. Tricks such as QEII can buy time but will not solve the problem. From the point of view of China, it is difficult to understand why the Chinese government should be so reluctant to reduce its current account

surplus against the US, meaning insistent to buy US government securities, while the securities are facing the danger of down-grading. From the point of view of the US, it is even more difficult to understand why the US government has been so intransigent in demanding China to reduce its current account surplus against the US, while it needs foreign funds to finance its budget deficit badly.

Figure 2. US government Debt



Although, the problem of global imbalances should be looked at within a broader framework, which takes into consideration total debt and total assets, and all major debt-finance links, the sustainability of global imbalances is still an important issue. Definitely, sooner or later, China will cut its current account deficit in a more earnest manner, because consensus has begun to arrive at recently that it is not in the interest of China to continue to pile up foreign exchange reserves by buying more US government securities, the value of which has already been diluted by the Fed's pump-priming. If the US government fails to find a way to cut its total debt, the fall in prices of US government bonds and the rise of the yields on these bonds will be inevitable.

The US needs both financial stability and growth. To achieve one should not at the expense of another. A sudden stop due to worsening of current account deficit is not an immediate threat. Until the US government and Fed have sold those toxic assets without causing upheaval in the capital market, we cannot say that the problem of household debt has been solved. Public debt has been worsening fast. The debt problem can be solved basically in two ways: the hard way—default and the soft way—pay down the debt by savings. There are two ways to increase savings: reduce consumption and make the economy growth faster. From America's point of view, it seems that the idea solution is to achieve higher growth by increasing exports. Suppose that by devaluation of the US dollar vis-à-vis the RMB, US current account deficit falls to zero, which, other things being equal, implies that the US economy grows correspondingly. Growth of the economy should increase government tax revenues, and hence the public borrowing requirements will be reduced. The need for foreign funds to finance budget deficit will be reduced at the same time. In this process, both current account deficit and government deficit will be reduced. This means that the growth rate of total debt has been reduced, while economic growth has also been achieved. The flip-side of the scenario is the weakening of the position of the dollar as the international reserve currency, and the possible negative impacts of the devaluation of the dollar on the rest of the global economy.

To allow the US to achieve a smooth adjustment by reducing total debt (or lower the growth rate of total debt) and increasing exports, international coordination is needed. On the other hand, US policies should be conducive to the maintenance of growth in developing economies and guarantee the integrity of the dollar. This means that the US should resist the temptation to inflate away its debt burden and shifting the burden of adjustment to the rest of the world.

The proposal of committing to reducing current account surplus by surplus countries is worth considering. However, this commitment must be combined with other commitments such as reducing budget deficit, reducing total debt-to-GDP ratio, controlling over operation of print press and so on. The coordination should be aimed at maintaining the growth momentum of the global economy, maintaining the financial stability and distributing the burden of adjustment in a fair way.

Appendix

Total debt must be equal to total assets +equity. But total debt is not necessary equal to its domestic assets +equity. Taking into consideration foreign claims on the US, we have the following relationship.

Mortgages and consumer credits of American households +American public debt + American business debt = MBS, CDO and other assets, US government securities, corporate stocks and bonds, held by Americans + [(foreign Miscellaneous Assets, US government securities, other bonds, corporate stocks, held by Americans, and outbound FDI) –(MBS, CDO and other assets, US government securities, corporate stocks and bonds, held by foreigners, and inbound FDI)]

Equivalently, we have

Net foreign debt = (mortgages and consumer credits of American households – MBS,CDO and deposits, held by American) + (American public debt – US government securities, held by Americans) + (American business debt – corporate stocks and bonds and deposits, held by Americans)

In flow terms, we have

Current account deficit = Δ(mortgages and consumer credits of American households – MBSΔCDO and consumer bank loans, held by Americans) + Δ(American public debt- government bonds held by Americans) + Δ(American business debt – shares and corporate bonds and business bank loans, held by Americans)

6. THE DEVELOPMENT AGENDA

DEVELOPMENT ASSISTANCE AT A TURNING POINT

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PROPOSAL FOR AN AID MODEL

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DEVELOPMENT ASSISTANCE AT A TURNING POINT

François BOURGUIGNON
Paris School of Economics

Very much criticism has been heard lately about Official Development Assistance by developed countries to developing countries. It is often seen as ineffective in promoting growth and reducing poverty. Even when restricted to social objectives like education or health, it is also found to be counterproductive through encouraging corruption and lack of accountability of political leadership with respect to their constituency, or even foreign donors. At the same time, it is difficult to imagine how a number of low-income countries would do in providing basic social services to their population without existing foreign assistance and how they could invest more heavily in infrastructure to promote faster growth without an increase in foreign assistance.

Development assistance is today at a turning point. If it makes little doubt that it needs to be increased overall, several factors suggest that the old model of aid delivery by a few official donors must be seriously revised to avoid it becoming still less effective.

Among the factors that push for a drastic change are the following.

The 'new' donors. Reflecting the asymmetry of economic growth in the developing world, the so-called emerging countries are increasingly present in poorer countries, most importantly in Sub-Saharan Africa. In a few years, China has been able to increase its funding of African development from practically zero to maybe 5 or $ 6 billion a year. The new donors often operate in the 'old' diplomacy-related style but they deliver aid in sectors and in ways radically different from those used by traditional donors, possibly making the latter less attractive and comparatively less effective. A good example of this is the focus of Chinese aid on infrastructure—an area long abandoned by traditional donors.

The aid fatigue in traditional donor countries. Aid being seen as ineffective, constituencies in donor countries can hardly be convinced to increase their effort, especially at a time of an economic slowdown. Moreover, observing how the new donors operate creates pressure to revert to old diplomacy-related aid model and away from multilateralism and restrictive DAC rules.

The growing sense of sovereignty and the increasing expertise in beneficiary countries are sapping further the old conditionality based aid model. Yet, aid cannot be exclusively delivered under the form of budget support, especially in 'fragile' countries.

The multiplication of aid actors. Because of some lack of transparency in multilateral agencies as well as the fear of corruption in beneficiary countries, several specialized multilateral funds have recently developed (GAVI, HIV/Malaria, …) in addition to existing specialized UN agencies. An increasing number of NGOs operate in the aid area funded both by private and public donors. Philanthropic foundations like the Gates and Buffet foundation are also increasingly active. The total amount of funds channeled towards developing countries by these 'private' actors was recently estimated to be around $ 50 billion a year, 40 per cent of total DAC aid. The increasing number of aid actors makes problems of coordination and harmonization, already serious among traditional donors, still more acute and potentially harmful to effectiveness.

Financial development. Globalization and innovation have substantially increased international flows in development finance with the effect of reducing the relative importance of aid flows, even in countries with limited access to international capital markets. This leads some observers to anticipate that private flows can progressively substitute for ODA. It is to be hoped that, together with more domestic resources, this will indeed happen in the long-run. For the time being, however, the issue is how to best combine the two types of flows while taking into account the relative role of private and public actors in development.

New tools. Innovations have taken place that may greatly modify the way to assist people in low income countries. Cash transfer policies of different types (conditional on the schooling of children, lump-sum pensions, etc..) can be effectively implemented today at relatively low cost thanks to the development of smart cards and mobile phones. Person to person transfers between developed and developing countries, including migrant remittances, become possible through these tools and internet. At the aggregate level, regular flows of foreign funds, including foreign aid, may be leveraged to increase the volume of investible resources, possibly

modifying the way aid may be used. The delivery of development assistance must take into account all these changes.

The focus on Sub-Saharan Africa and other poor countries. Although some progress has been recorded over the last decade in the pace of Sub-Saharan African growth, the region still lags behind most other developing countries both in income levels and rates of growth. With current trends, global poverty will increasingly become an African problem over the next 20 years. On the other hand, it is not clear that the good performance of African countries over the last couple of years reflects on average more than favorable commodity prices and that commodity exports could be a powerful long-run development engine. Under these conditions, development assistance should increasingly focus on that region. It should also go beyond standard aid to cover other ways of creating the conditions for sustained development there (most notably through effective trade preferences).

Climate change and global public goods are opening new opportunities or new obligations to foreign development assistance. The anticipation that global warming will predominantly affect negatively the poorest countries has led to a reflection on how to mobilize resources to finance *adaptation* to the climate change. The High-Level Advisory Group on Climate Change Financing just released a report on how to mobilize $ 100 billion/year by 2020. An important issue is how to make sure that this funding will be truly *additional* and will not affect ODA flows. The same applies to other global public goods or 'global public bads' likely to affect poor countries: conflict prevention, trade infrastructure, pandemics prevention, etc… Globalization entails the development of global negative externalities that may hinder the economic development of poor countries. It is essential for them to be fully compensated without implicit reduction of ODA flows.

Such are the challenges that traditional and new ODA, whether public or private, is facing. Clearly, the old model of a few donors and a few bilateral or multilateral agencies financing specific projects or sectoral programs in developing countries fits less and less well this context. Yet, 'project aid' still is the dominant form of aid delivery today, both by public agencies as well as NGOs or private foundations. The major risk that is being faced with the present organization (or disorganization) of aid is an increase in its effectiveness for lack of coordination of the various actors, both in donor and in recipient countries. From that point of view, it is somewhat surprising that rather little was said in the Seoul Development Consensus promoted at the G20 summit in Korea about the implementation of the general strategic principles listed in the communiqué. There definitely is an

agreement on these principles and on the 'key pillars' proposed in the communiqué. But the issue of implementation and the best way of federating all the energies to reach the development goals reiterated in that document has received little attention. The decisions taken in previous conferences on aid effectiveness in Paris and Accra were too general, mostly focused on traditional donors and old aid delivery mechanisms and ignorant of the new context and new challenges to aid delivery.

The whole traditional aid system has become too complicated, involving too many actors and too many dimensions to be handled through conventional planning and coordination tools. It is necessary to think about innovative ways of handling aid in order not to lose and possibly gain effectiveness. Beyond principles, it should be the task of the G20 to propose ways to reach that objective, especially in view of the conference on aid to take place at the end of the year in Korea. From that point of view, a few practical and inter-related principles might be kept in mind for designing an adequate and effective aid system.

Transparency should be the master word. Aid is presently ineffective (or is perceived so) precisely because of the lack of transparency of the whole system. If all donors were transparent about the way their aid is allocated among countries, and possibly among sectors, if serious *impact evaluation* was undertaken of all specific projects or programs supposedly funded by foreign assistance, if recipient countries were transparent about their public expenditures, including those funded by foreign assistance, if they were seriously monitoring their development progress and the effectiveness of their own policies, again through rigorous impact evaluations of some of their major programs, things would be fundamentally different from what they are today. Transparency would reveal ineffectiveness and ineffectiveness would be corrected, in donor countries because of tax payers' pressure, recipient countries because of popular control and the risk that aid flows would fall if effectiveness is seen to be limited.

Relying more on budget support

Provided it is possible to get real transparency in recipient countries, then budget support rather than project aid must become the norm. The problems arising from the lack of coordination of aid actors and lack of harmonization of their modus operandi will be reduced in the same proportion as the increase in the share of budget support in total aid. Also, actors concerned with these problems will increasingly be private actors, supposedly more flexible in their operations. In Sub-Saharan Africa, budget

support may represent about 20 per cent of DAC reported aid, but much less as a proportion of total aid.

Decentralization to specialized (public or private) agencies

Outside budget support, it is not clear that national development agencies are the most efficient instruments to directly manage project or program aid when dealing with a multiplicity of countries and project types. Specialized agencies, whether public or private, would certainly do much better and this may be a reason for the relative good performance of various UN agencies or global funds. Project aid delivery already works a little as a market where operators specialized in a given field and a given set of countries collect aid from donors and are responsible for the implementation of a specific project. Provided that these operators are fully transparent, it would be possible to go beyond this, however. Operators could be managing their own projects, using the most efficient tools available and designing innovative ones, and would attract more or less aid from donors depending on the results they have been able to show through careful evaluation of their operations. In effect, private aid is more or less managed in that way. The problem is that it may not be extremely effective because money is not collected on the basis of a rigorous evaluation of the action of operators but through advertisement campaigns. One could even imagine that operators would be rated by some entity representing the community of public and private donors.

Division of labor

The preceding principles (budget support, decentralization) already rely on a clearer division of labor in aid delivery. Addressing some of the challenges above also requires making sure the adequate allocation of aid funds across areas of interventions (global public goods vs. development objectives) and geographical areas (Sub-Saharan Africa and other poor slow-growing countries vs. other regions). It will probably be difficult to achieve this through loose coordination of donors. Part of the solution consists of entrusting part of this allocation process to multilateral institutions specialized in financing actions in given areas or regions (like Regional Development Banks). For global public goods, this will probably require either creating new institutions or delegating the management of a specific area – e.g. adaptation to global warming – to existing multilateral institutions like the World Bank or the IMF.

These principles are indicative of directions for in depth reflection on the necessary reforms of the aid sector. It might be thought that the

multiplicity of actors that was emphasized above is making things extremely complicated. This is not completely true. Traditional DAC donors are still responsible for two thirds of total development assistance in the world. Reforming the way they manage and deliver their aid would necessarily have a huge impact at the global level and will affect the way in which other donors, public or private, operate. In effect, it is most likely that other actors will join. In particular, nothing should prevent emerging countries in the G20 to join traditional donors on specific reforms or to adopt some of the previous practical principles.

PROPOSAL FOR AN AID MODEL

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In 2000, the nations of the world adopted the UN Millennium Development Goals (MDGs); which include the reduction of extreme poverty, disease, child mortality, climate change and gender inequalities, and the improvement of primary education and maternal health. The MDGs are the only credible framework for the international community's response to these problems.

The MDG programme needs funds. The 192 UN member governments backed these goals. The developed nations pledged to raise their aid to the developing nations to 0.7 per cent. of their national incomes to meet the need. Only five of them have so far reached this target. Most contribute less than half the pledged level. In 2009, the shortfall was $146B, roughly 56%. If the promised contributions to achieving the MDGs are not achieved, there will be greater human misery and global insecurity. The MM Aid Model provides a way for Nations to move faster toward meeting this funding shortfall.

The MM Model – Transforming Aid

Matching private donations

Donations can be increased both by greater public awareness of the good done by fulfilling the commitments of the MDGs; and by increasing the incentive to make donations. We propose that governments use part of their overseas development assistance (ODA) budgets to match private

24. This note is an abbreviated statement of a proposal that Renu Mehta (Director of Fortune Forum, London) and I have developed.

voluntary donations. From the individual's point of view, a donation would achieve twice as much as the donation on its own, considerably increasing the incentive to donate. These private contributions, along with the matching public funds, would be channelled through to a special fund, to be set up by government or the government aid agency. We call this fund the Global Development Fund (GDF). Matching would be conveniently achieved for most people by allowing them to make voluntary donations to the GDF along with their tax payments.

Every donation made to the GDF by a private individual, a foundation or trust, or a company should be matched by an equal contribution from the government's aid budget earmarked for matching; a part that, in the absence of the scheme, would have gone to government aid agencies directly and unconditionally. Donations to the GDF can be made along with income-tax payments and corporation tax payments, and may take the form of legacies. Donations may be made by non-domiciled and non-resident income earners, and from accumulated wealth, including funds held offshore. Funds to match private donations would come from the aid budget: a substantial part of the budget would be so used.

Tax payers would be invited to donate at least 0.7 per cent of their taxable income. That amount would be collected with their tax payments, unless they chose to opt out, or chose a different level of donation. This proportion echoes the commitment to increase government development assistance to 0.7 per cent of GDP. Businesses would similarly be invited to donate a minimum of 0.7 per cent of their net trading profits. We would expect many higher income earners and businesses to donate a greater proportion than 0.7 per cent.

If implemented by all OECD nations the model should bring in new money of more than US$100 billion per year. To achieve such a high level of additional donations, all OECD member states would have to implement various aspects of the MM Model such as additional monitoring of funds and specialist donor support. An exceptional matching incentive alone will not work—Governments have to accept an independent evaluation process.

- **Achieving and demonstrating successful aid**

The GDF, in association with the government's development agency, needs to do a serious job of allocating its funds. It must establish rigorous monitoring arrangements to provide appropriate incentives for the governments, agencies and Non-Governmental Organizations (NGOs) receiving its funds to act and cooperate effectively. It should counter the inefficient use of development assistance, and reduce losses to wasteful

administration and corruption, which are among the reasons why donations to these causes are so much less than their importance requires.

To increase donor motivation largely depends on the creation of this specialist investment vehicle, GDF, designed to ensure that the donors' resources are delivered with the highest possible impact. We suggest that a GDF index of independently-audited projects and initiatives should rank aid expenditures by their impact and results. That would provide a competitive environment amongst grantees. It would reward good performance, improve or eliminate inefficient programmes, and facilitate better coordination of aid efforts. The result would be a higher yielding portfolio of development programmes. The GDF would have two tasks of the first importance, to assess performance and to inform public perceptions.

- **Transparency to build public confidence**

The GDF would have the responsibility of monitoring the effectiveness of its expenditures, and publicising achievements, to show that the donors' performance expectations are met, and communication with the private sector. By doubling donations, and channelling them through a trusted body, we seek to create a large multiplier effect to attract donations from the private sector. Donors are to be given good information about development programmes they have financed through the GDF, information that should be publicly and transparently available.

Donors contributing through the GDF can be confident that their giving will be channelled successfully, because of the GDF's independent audit of the whole distribution process, from the criteria driving allocation of funds across the eight MDGs through to assessment of the effectiveness of proposed recipients, and subsequent evaluation of results obtained.

Spending to achieve the Millennium Development Goals, which can be greatly increased by the MM Model, would give the world's poor access to food, shelter, education, water, healthcare, a cleaner environment and greater equality; and protect future populations from the risk of excessive global warming. It deserves the highest priority.

7. CROSS-CUTTING ISSUES

GLOBAL GOVERNANCE, THE NTERNATIONAL MONETARY SYSTEM AND THE DEVELOPMENT AGENDA

Venugopal Y. REDDY – *LSE*

THE G20 PROCESS, THE INTERNATIONAL MONETARY SYSTEM AND MACROECONOMIC STABILITY

Eisuke SAKAKIBARA – *Aoyama Gakuin University*

SUSTAINABLE FINANCING FOR DEVELOPMENT

Heidmarie WIECZOREK-ZEUL – *Bundestag*

GLOBAL GOVERNANCE, THE INTERNATIONAL MONETARY SYSTEM AND THE DEVELOPMENT AGENDA

Venugopal Y. Reddy
LSE

Global Governance

G20 should not supplant existing multilateral institutions since they have universal membership, accumulated expertise and insights. The G20 can only supplement the working of these institutions and provide overall guidance as appropriate.

G20 should not, therefore, have a separate permanent secretariat. Informality is its strength and, therefore, its deliberations and outcomes should not be driven by own secretariat.

The current mechanism of working groups on an adhoc basis also provides a greater sense of participation to different countries, depending on their stakes and their relevance. For instance, it is not an accident that India and Canada are closely involved in some of the critical working groups.

Moreover, it must be recognized that G20's importance has been basically contextual and perhaps rightly so. When there are challenges, there is a greater compulsion to coordinate. When there are more normal times, all the institutions that have been established for specific purposes should have the policy space to conduct their activities as per their mandate. It is recognized that there is a deficit in the governance of many of these institutions. However, it is natural that the importance of G20 will diminish, and should diminish, as and when the governance in these institutions like IMF and World Bank improves.

Global Economic Coordination Council has a logic of its own, and it should be pursued vigorously as an independent body of experts. It would

be appropriate for G20 also to draw on the expertise of the proposed Global Economic Coordination Council.

Briefly stated, G20 should be treated as a group of systemically important countries which will deliberate on mechanisms by which the conflicts between the policy space necessary for national governments which are accountable to people and the normal global arrangements are resolved; and, this is best done through dialogue and peer pressure. G20 should have the liberty to draw on experts including, in particular, Global Economic Coordination Council, apart from IMF and World Bank.

However, it is necessary to ensure that G20 considers formally and seriously the Report of the UN Commission of Experts, and takes a view on its recommendations.

In the light of the above, the review of the existing institutions should be considered institution-wise, and with reference to weaknesses. In a way, reform has to be incremental, but urgent and significant.

My views on the G20 have been articulated in my recent book titled "**Global Crisis, Recession and Uneven Recovery**", in Chapter 20 (G20 Framework: Review and Prospects). Soft copy is attached.

Reforming the Monetary and Financial System

On the global reserve system, the longer term goal should be a global currency. In the meantime, every effort should be made to make SDR popular, while the multi polar reserve currency appears inevitable in the short run, with U.S. Dollar continuing to be dominant but possibly less than before.

However, it may be useful to note that the real issue is not demand due to forex reserves of governments, because it is possible for major reserve currency holders to agree to mimick the currency composition of SDR in their reserve management.

In regard to the financial sector regulation, the major issue is the cross border activities of the financial conglomerates and the cross border flows. This area has been entirely neglected by the current discussions.

The utilization of regulation of financial sector for financial stability is emphasized, but not for promoting growth. This imbalance should be rectified by focusing on instruments of regulatory policies that can facilitate growth, including, in particular, employment and financial inclusion.

Taxing financial sector should be on the national agenda, particularly to avoid excessive financialisation and distorted incentives. Global agreement on taxation can be independently pursued.

Macroeconomic and Stability Issues

In analyzing the macroeconomic and stability issues, it must be recognized that growth and stability are essentially the subject matters of elected governments at the national level, since they are accountable to their people. All global institutions are in the nature of arrangements between the national governments. Hence, any approach to the global macro economic and stability issues should focus on the spill-over effects of national policies on the global economy, and in particular, spill over effects of those countries which are issuing reserve currencies and those countries which are contributing to global economic imbalances.

In this regard, the importance of Euro Area should be recognized by the global community and it should be supported in resolving what has been eloquently described as "Policy trilemmas". Euro Area has the potential to contribute immensely to the global architecture and governance reform.

The Development Agenda

In analyzing the issues relating to development, particularly of developing economies, the follow basic issues may be addressed.

- First, globalization of finance is different from globalization of trade.
- Second, financial markets are different from the markets in goods.
- Third, banks among financial institutions are different and are in the nature of public utilities.
- Fourth, some financial instruments are good and some others are toxic. The burden of poof that they are not toxic should be on the markets.
- Fifth, the depositors' interest and savers' interest should be supreme because in the final analysis, growth has to be funded essentially by domestic savings and foreign savings are only a supplement.

The most **critical** issue for developing countries in the near to medium-term relates to volatilities and uncertainties in the financial markets. In addition, the huge demands of public debt by the advanced economies on the global savings and their budget constraints affecting aid flows could cumulatively create a stress on the assured availability of both private and public sector capital flows to the developing world. Some firm assurances to provide comfort in this regard may be essential for many of the low income countries.

THE G20 PROCESS, THE INTERNATIONAL MONETARY SYSTEM AND MACROECONOMIC STABILITY

Eisuke SAKAKIBARA
Aoyama Gakuin University

International monetary and financial system

(i) New Breton wood Conference

Several key countries' (U.S, Europe, Japan, China, India) representatives should be convened to discuss a new system of international monetary regime. U.S. dollar would continue to be the major transaction currency but some mechanism needs to be created to strengthen smooth transactions. Additional increase in SDR allocation with substantial quantity should be one of the measures to be implemented.

(ii) Dollar vs. Asian Currencies

Given relative economic conditions between U.S. and Asian countries, the U.S. dollar would continue to decline vis-à-vis Asian currency including Chinese Yuan and Japanese Yen. Discussions among countries concerned should be held to smooth out the process. In particular, confrontation between U.S. and China over currency issues should be avoided as much as possible.

G20 Process

Inner circle of G20 should be created to make discussions and deliberation more effective. Core members should be five to six. Members could form five to six groups and representation for the group could be on rotating basis. A secretariat should be created that serves for five years or so and the secretariat should be selected from aforementioned five to six groups. After the first five years, the secretariat should change. The

secretariat should get in touch with the IMF, the World Bank and the WTO to obtain their support.

Macroeconomic and stability issues

(i) A new forum could be created to coordinate monetary and forex policies. In particular, a tripartite forum among U.S, Europe and Japan should meet and discuss regularly to avoid competitive monetary easing and currency war.

(ii) IMF consultations with developed countries could be held more frequently, say, a few times a year and on the basis of such consultations, meetings among developed countries, U.S, Europe and Japan should be convened.

(iii) Also, meeting with China and India with developed countries could be held regularly with IMF as the secretariat.

SUSTAINABLE FINANCING FOR DEVELOPMENT

Heidmarie WIECZOREK-ZEUL
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In the year 2000, the international community agreed the Millennium Development Goals (MDG), a set of fundamental, binding goals for a sustainable and equitable development policy. The Millennium Summit marked the start of a discussion on financing the necessary measures which was continued at the International Conference on Financing for Development in the Mexican city of Monterrey in 2002. At the Monterrey Conference, developing and industrialised countries looked for the first time at all the conceivable sources of financing for development. In the Monterrey Consensus they agreed to increase official development assistance (ODA), generate more foreign direct investment, mobilise domestic financial resources in developing countries and reduce international trade barriers. They also agreed a debt relief initiative and sought greater involvement on the part of developing countries in the reform of the international trade and finance architecture and in the planning of international development cooperation. The Doha Declaration of December 2008 reaffirmed the Monterrey Consensus in its entirety and highlighted certain new areas of concern. The outcome document contains the renewed commitment to mobilise all possible financial resources to achieve the internationally agreed development goals and to eradicate poverty. The Member States of the European Union pledged in 2005 to increase spending on official development assistance to 0.51 per cent of gross national income (GNI) by 2010 and to 0.7 per cent of GNI by 2015 on the basis of a phased plan. New Member States which joined the EU after 2002 are committed to achieving a quota of 0.33 per cent of GNI by 2015.

During the economic and financial crisis, the industrialised countries introduced stabilisation programmes to strengthen their economic and

financial structures. As part of the associated exit strategies they are now gradually reducing their debt levels. This could well have an impact on the amount they spend on development assistance. Any such cutback in official development assistance would lead to a shortfall in funds for such urgent tasks as the worldwide fight against poverty and climate change. One serious consequence of this would be a loss of confidence on the part of developing countries in the industrialised countries since the latter have failed to keep their promises. This in turn could lead to hunger riots and growing crises. The interim assessment of progress towards achievement of the Millennium Development Goals at the follow-up conference in New York in September 2010 reflected these concerns. The conference identified progress in the areas of education and the control of HIV/Aids, malaria and other transmittable diseases, resulting in part from the work of the Global Fund. Little progress has been made, however, in reducing child mortality and improving the health of mothers.

While private finance initiatives have certainly achieved some noteworthy successes, their limitations have also become clear. In times of crisis there is a great danger that private companies acting as financial backers will withdraw from a country and prevent the establishment of a sustainable system to finance development. Private companies have actually done this even in relation to microfinance institutions.

The industrialised countries must keep their 0.7 per cent promise. One way they can do so is by increasing budgets. But there is also a need to identify innovative sources of financing if the Millennium Development Goals are to be achieved on time and in full. The financial transactions tax offers a good way to enforce the "speculator pays" principle and ensure that the financial services industry share the costs of the crisis.

Many European countries have now announced their support for a tax on financial transactions. Every effort must therefore be made to ensure a positive outcome at the next G20 round – if necessary in association with the group of those countries which would like to take a leading role during the implementation phase of such a tax. The financial sector must do its part to tackle the aftermath of the financial crisis. A tax of this nature would discourage short-term transactions and at the same time mobilise billions globally for the fight against hunger, poverty, joblessness and climate change.

In addition to increasing ODA and introducing a financial transactions tax, it is also necessary for the developing countries to boost their own incomes. They must be given assistance to establish their own tax systems

since experience indicates that this generates a two to threefold increase in revenue.

The financing of development must at the same time be part of a worldwide growth strategy which seizes the opportunity to establish stable and sustainable markets. Industry should make a contribution to sustainability in the form of global green investments.

Cooperation agreements between the industrialised countries and new donor countries such as China, India, Brazil and other developing countries can be used to exchange know-how and financial resources and to work together towards the achievement of the Millennium Development Goals.

There is no lack of ideas as to where money for development cooperation could come from. Rather, when budgets are cut and cooperation agreements fail to materialise, this is more a demonstration of a lack of political will. We should not allow ourselves to go down in history as the generation which spent billions on bailing out the financial sector but did not have the strength or the will to save the world from hunger, poverty, unemployment and climate change.

THE G20 AND RECOVERY AND BEYOND

AN AGENDA FOR GLOBAL GOVERNANCE FOR THE TWENTY-FIRST CENTURY

A group of 'experts', with no commitments other that of being citizens of the world, decided to meet to reflect on what could be done in the present situation, hoping that from their reflection some useful recommendations to the powerful of this world would emerge. This group, which christened itself the Paris Group, has been constituted at the invitation of the President of the French Republic, who also presides over the destiny of the G20 this year. The Chairmen were given complete discretion in the choice of the membership of the group; their sole responsibility was to gather a diverse group of individuals with the highest level of expertise in the subjects confronting the G20 and with a commitment to working to ensure the improvement in the system of global economic governance.

The chapters which compose the ebook contain a summary of the discussion between the members of the group prepared by Jean-Paul Fitoussi and Joseph Stiglitz and the preparatory notes which have been written by them.

Chairs:

Jean-Paul Fitoussi is professor of economics at LUISS Guido Carli University, Rome, and Director of research at OFCE, Paris of which he was President from 1990 to 2010. He is also emeritus professor at Sciences Po, Paris.

Joseph E. Stiglitz is a professor of economics at Columbia University and the recipient of the John Bates Clark Medal and a Nobel Prize. He is also the former senior vice president and chief economist of the World Bank.

Other members of the group: **Arrow** Kenneth J., **Arestis** Philip, **Besley** Tim, **Bougrov** Andrei, **Bourguignon** François, **Bourguinat** Henri, **De Cecco** Marcello, **Dervis** Kemal, **Johnson** Robert, **Kasekende** Louis, **Mirrlees** James Alexander, **Ndikumana** Léonce, **Ocampo** José Antonio, **Paez Perez** Pedro, **Persaud** Avinash, **Reddy** Venugopal Y., **Sakakibara** Eisuke, **Stern** Nicholas, **Wieczorek-Zeul** Heidemarie, **Yongding** Yu, **Zeti Akhtar** Aziz.