Global Cooperation Among G20 Countries: Responding to the Crisis and Restoring Growth

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1 Introductory Chapter

Since the unfolding of the 2008 global financial crisis, the G20 has played a major role in coordinating macroeconomic policies of major economies and reviving the world economy.[1] As the world's primary forum for international economic cooperation, its objectives have been to ensure more sustainable and balanced growth, achieve economic and financial stability and reform the prevailing international financial architecture. In the wake of the crisis, there was a sense of urgency and strong agreement to enact extraordinary policy measures to fend off the collapse of the real sector because of the "collapse of confidence" in the financial sector. The G20 performed spectacularly in this regard: global gross domestic product (GDP) contracted less than expected in 2009 and rebounded faster than expected in 2010.[2]

[1] The global financial crisis of 2008 required a more legitimate and representative forum than the G8 if it was to effect global macroeconomic and financial policy coordination to ward off imminent depression. It was in this context the G20 Leaders Summit was born.

[2] World Economic Outlook (April 09) predicted that world output would contract by 1.4% in 2009 and grow about 2.5% in 2010. However, the actual outcome was −0.5% in 2009 and a 5% growth in 2010 (Ahluwalia 2011).

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M. Callaghan et al. (eds.), *Global Cooperation Among G20 Countries,*
DOI 10.1007/978-81-322-1659-9_1, © Springer India 2014

These coordinated actions were widely credited for forestalling a second Great Depression, with the G20 declaring victory at their third summit at Pittsburgh in September 2009 ("It worked").

Since 2009, Indian Council for Research on International Economic Relations (ICRIER), along with its partners, has been organizing a high-level annual conference that brings together academics and key policymakers from G20 member countries and International Financial Institutions (IFIs) to deliberate on a range of issues related to the G20. The previous three ICRIER conferences in this series, held prior to the Toronto, Seoul and Cannes G20 summits, had deliberated on the then G20 agenda. Succinct summaries of these conferences have been published and widely circulated among IFIs, think tanks and government officials in both India and abroad. The proceedings served as inputs to policymakers participating in the summits. ICRIER hosted its fourth G20 conference on October 7–9, 2012, at New Delhi in partnership with the Asian Development Bank Institute (ADBI), Department of Economic Affairs (DEA, MoF), International Monetary Fund (IMF) and Konrad-Adenauer-Stiftung (KAS).

Discussions in the fourth conference focussed on six key areas of concern facing the G20:

1. The eurozone crisis: short-run challenges and options
2. Rebalancing the global economy
3. Financial sector regulation
4. A new framework for reforming the international monetary system
5. Capital control policy and emerging market economies
6. Austerity and growth

The overarching theme of the conference was the scope for cooperation and coordination amongst the G20 across several key policy areas.[3] Several issues relating to cooperation and coordination in macroeconomic policy were discussed: the relative efficacy of rules versus discretion-based coordination[4]; how to achieve cooperation across a diverse set of countries especially when cooperation also requires loss of national interest; has the G20 process run its course; how can the process be made

[3] There is a large theoretical literature on the international coordination of macroeconomic policy. See Pilbeam (2006) for a textbook treatment. The principal argument in favour of international coordination is that governments will be tempted to pursue suboptimal policies without it. In short, there will be a failure to internalize the externalities, with the uncoordinated approach leading to Pareto inefficient outcomes. Bird (2012) however argue that policy coordination does not necessarily imply Pareto efficient gains as individual countries may perceive that they would lose from coordinating macroeconomic policy when they subvert domestic policy preferences for policy outcomes that are seen as jointly superior. Further, the bargaining position of individual countries is unlikely to be equal in securing a coordinated outcome.

[4] International policy coordination can take two broad forms: discretion-based cooperation or rule-based coordination. While many examples of policy coordination favour rule-based coordination, discretion-based cooperation is typically superior given extreme unanticipated events for which the existing set of rules cannot cope (Bird 2012). From this standpoint, the London summit of the G20 in April 2009 was an attempt to organize discretion-based coordination.

more inclusive; can the G20 regain its stature as a problem-solving group; how can the G20 strengthen its key function of providing crisis management mechanisms; and given that the basic rationale for the creation of the G20 leaders' process was to manage shocks transmitted by and through the group, how can it best do this.

In addition, broader issues surrounding the role of the G20 in macroeconomic policymaking were also discussed. For instance, many participants felt that the G20 was an informal and political body that brought together the biggest economies in the world as a problem-solving group that looked to the future. To be effective, it should remain a leader's forum. Some participants felt that there were two subgroups in the G20—the BRICS and the G7/G8. These groups brought a flavour of the past North/South divide, which may limit the sense of a common purpose among G20 members. For legitimacy, various participants felt the need for G20 countries to work more closely with non-G20 countries. Legitimacy would also involve a stronger and more independent accountability process, with regional arrangements linked to the G20. Other points mentioned included a lack of resource commitments by G20 members, that initiatives by the chair were over-emphasized and the credibility of the G20 was hampered by delay in implementing commitments.

Finally, participants felt that there is further scope for cooperation in other areas such as the consultation process and addressing the pace of IMF reforms. Predetermined policy options undertaken by the G20 through a consultation process did help in feeding back into national policymaking processes.[5] This suggests that the role of the G20 as a coordination mechanism will be crucial. Further, the process of reforming international financial institutions has been slower than what the dynamic emerging economies would like. Reforming the composition of the IMF Executive Board to better reflect the changing economic power of member countries would help enhance the IMF's credibility in surveillance and policy advocacy.

1.1 Format of the Volume

Invited contributions from participants in the conference have been divided into six sections which directly mirror the conference agenda. Each section contains one lead chapter by a conference participant which provides an extensive review of the issues of concern for that section. These lead chapters are supplemented by shorter notes by other participants in that session of the conference.

The volume opens with an introductory chapter by the editors outlining the scope of the material covered and synthesizing the rich and broad discussion during the conference. The keynote address delivered by Subir Gokarn (Former Deputy Governor, Reserve Bank of India) constitutes a special opening chapter to the volume.

[5] For example, the Chinese 12th 5-year plan document pretty much reflected what the global community wanted of it.

1.2 Overview of Keynote Address

In his keynote address, *Subir Gokarn* argues that a number of stress points have emerged in the global economy. Given these, he poses the question whether the G20 can regain its stature as a "problem-solving" group, or whether it is just a "wartime" grouping that only works when a crisis is at hand.

The author observes that the emphasis of the G20 has shifted from immediate crisis management to addressing some of the structural factors that were widely seen to have played a role in causing and spreading the financial crisis. This has made the G20 a testing ground for providing a viable solution to macroeconomic policy coordination amongst heterogeneous economies. But the ease with which consensus across the group was found in "wartime" is not being replicated in "peacetime." Given the relatively large number of issues over which coordination is required, the number of possible coalitions and the membership of each country in multiple coalitions raise concerns about the sheer complexity of the coordination process.

2 The Eurozone Crisis: Short-Run Challenges and Options

The Euro crisis has loomed as a major threat to global recovery since 2011. A number of uncertainties, including concerns over whether Greece might have to exit the euro (see Buiter and Rahbari 2012), the crisis in the euro periphery and the fear of a prolonged recession in the euro area, made markets nervous.[6] One reason for market anxiety—and recurring shocks—is the abysmal crisis management by European policymakers. Solvency problems in the periphery countries were initially treated as a liquidity problem, and the proposed support was inadequate, misguided and arrived late.[7] Another problem in Europe was that no orderly mechanism existed for allowing struggling banks to fail (as there was in the USA)[8]. Participants in the conference felt that several risks remain elevated and crucial questions unanswered, such as:

- Why are financial markets still nervous about prospects in the eurozone?
- What reforms are needed to prevent the implosion of the European currency union?
- What is the efficacy of unlimited liquidity as a response to a banking capitalization crisis?

[6] Since 2012 however, coordinated implementation of bank liquidity support, including in particular the Outright Monetary Transactions operation by the European Central bank, along with capital regulation in the euro area and well-guided national policies, has helped calm financial markets.

[7] First the crisis in Greece was denied, then diagnosed and treated for a liquidity problem while it was a solvency problem. Further, ECB worsened market sentiments as it demanded preferred creditor's status after buying Greek bonds on the secondary markets.

[8] For example, the Federal Deposit Insurance Corporation has closed 448 banks since 2008.

- To the extent that debt mutualization is necessary in the euro area, how it could be managed, especially in terms of moral hazard, and how quickly could it be implemented.[9]
- How Grexit or, more broadly, the collapse of the European currency union would play out?
- What are the ways to achieve better fiscal coordination and risk sharing among euro area countries in the medium to long run?
- How would fervent fiscal conservatism in Europe affect European growth prospects and the government finances of member countries, and what would be the impact on the rest of the world (especially EMEs)?
- How can national economies support growth in the short term while maintaining long-term commitments to achieving sustainable fiscal positions?

In the lead chapter entitled "Overcoming the Euro Area Crisis: Reforms and Results," *Holger Fabig, Yannick Kirchhof and Inka Zippe* argue that considerable policy initiatives have been implemented including establishment of the European Stability Mechanism (ESM), a sterilized open-ended bond purchase programme by the European Central Bank (ECB), fiscal consolidation programmes in member countries and the possibility of the direct purchase of sovereign debt by the ESM. Effective fiscal consolidation[10], an early warning system to manage potentially harmful internal macroeconomic imbalances, and the Europe 2020 strategy[11] for strong and sustainable growth have resulted in a marked decline in current account deficits, increased exports and improvement in the competitiveness of the periphery, while wages have increased in France and Germany. An intergovernmental treaty (the Fiscal compact) has been introduced as a new, stricter version of the Stability and Growth Pact. By signing the treaty, 25 countries have committed themselves to introducing uniform, long-term budgetary rules into their national legal systems, preferably at constitutional level. The *European Semester* has also been adopted by the European Council and launched in 2011, with a central task to coordinate economic policies and structural reforms. This improves the integration and implementation of fiscal and economic reforms in the eurozone. The authors also note progress regarding budget balances in the euro area. In particular, structural budget deficits fell on average in the euro area from 6.3 % in 2009 to 3.3 % in 2012. Another key reform step has been the deepening of European banking sector integration. In this

[9] Some argue that debt mutualization should be partial, i.e. the EU should put in place a mechanism for internal transfer where less creditworthy nations should compensate the more creditworthy ones and for monitoring fiscal progress of member countries, and also ensure that the national governments remain responsible to reduce deficits.

[10] Nominal budget deficits declined from 6.4 % in 2009 to 3.2 % in 2012 for EU as a whole, while structural deficits corrected for the business cycle declined from 4.6 % to 2.1 %.

[11] Europe 2020 is a strategy adopted by the European Union to address the shortcomings in the growth models of European countries targeting specifically education, research and innovation, social inclusion and poverty reduction, and climate/energy for achieving smarter, more sustainable and more inclusive growth.

context the discussion of a European Banking Union with bank supervision function has been pushed forward. In sum, the authors argue that Europe has responded effectively and collectively.

Abheek Barua takes a contrasting position and argues that the recent crisis in Cyprus highlights the absence of an established and replicable model for crisis resolution in the euro region. The possibility of a deposit tax not only enhances the risk of bank runs across the region but also could generate sudden stops in liquidity as lending banks became apprehensive that there may be a quick erosion in the liability base of debtor banks.

What is the future for Europe and the euro? Does Europe need more or less integration? There are two views here. First, some participants felt that extensive integration—uniform economic policy and equal social security for all—would do justice neither to the European history nor to the preferences of the people. Economic centralization has a failed history: indeed, super-national banking supervision such as Basel I and II did not help prevent banking crises. The alternate view is that a common framework for supervision, regulation and resolution is necessary as Europe enjoys a common currency and capital market, and has extensive cross-border financial flows within the region. This division of views is taken up in two separate notes by *Heribert Dieter* and *Pierre Jacques*. *Dieter* argues that if governments and institutions like the ECB keep coming to the rescue of the financial sector, the players will become less prudent in the future. Rescue operations will lead to moral hazard. He also argues that Europe can strengthen the ownership of economic and fiscal policies by providing incentives for sustainable economic development. A key provision here is to eliminate the contradictions and inconsistencies of the Maastricht Treaty. *Jacques* argues that there is a clear lack of long-term and shared vision about European integration. Dealing with this requires strong political mobilization. This is the deepest challenge facing Europe currently.

In sum, while Europe's short- and long-run reform initiatives to tackle the euro crisis—fiscal consolidation and steps to improve competitiveness—have been promising, a dominant view was that Europe needs stronger coordination. This implies managed integration to ensure internal burden sharing, restore competitiveness and enhance potential growth.[12]

[12] The session also discussed what would be the likely implication of euro crisis on the Exempted Micro Enterprises (EMEs) and India. Is the slide in growth correlated with intensification of the eurozone crisis? EMEs—like India—would be affected by the crisis through three channels: (1) the confidence channel transmitted through financial markets, (2) regulation-triggered deleveraging of European banks may hurt the quantum of funds available to EMEs and (3) the trade channel. The implications for India would be severe as the EU is India's largest trading partner and half of external commercial borrowings in India are from European banks.

3 Rebalancing the Global Economy

Global macroeconomic rebalancing received considerable attention in the conference. While several issues remain contentious, a general consensus has emerged that reprioritizing domestic policies and reducing domestic distortions are key to rebalancing in an interconnected world. The focus of the debate was on understanding the extent of global macroeconomic rebalancing already achieved, and the need to develop a forward-looking perspective for understanding the changing nature of imbalances. Participants recognized that global imbalances are also dynamic: while the main source of global deficits remains largely the same, the source of global surpluses is now the oil-exporting countries (petrodollars) as opposed to manufacturing-intensive exporting economies (trade surpluses). The changing nature of imbalances—trade surpluses vs. petrodollars—has important implications for reserves and capital flows, and for policy responses.

Did the imbalances in 2008 cause the crisis? While some would argue that it is not external imbalances but financial regulatory failure that caused the crisis, a prevailing view (held, for instance, by Mervyn King and Ben Bernanke) appears to be that global imbalances fuelled the crisis through creating asset bubbles. However there have always been global imbalances: in the 1990s, the widening US deficit was matched by increasing surpluses in Japan and East Asia; in the early 2000s the rise in the US deficit reflected falling US domestic savings rather than strong domestic investment, while during 2004–2008 the US deficit remained large but was matched by a sharp increase in surpluses in China. What is different is the magnitude of the imbalances in the immediate lead-up to the crisis.

In the lead chapter, *Michael Callaghan* argues that the issue of global imbalances should not be presented in terms of a concern over global imbalances per se, but that removing distortions that result in 'bad' imbalances is beneficial to all. He emphasizes that external imbalances are a symptom of structural factors and policy distortions. Hence, not all imbalances are necessarily 'bad'. Imbalances may, for example, be a result of inter-temporal optimization by the private sector. For example, a country with an ageing population relative to its trading partners may choose to save and run current account surpluses in anticipation of dis-savings in the future when the workforce shrinks. Likewise, a country with more investment opportunities relative to its domestic savings will draw on foreign savings. Alternatively, policy distortions that can result in 'bad' imbalances include an export-led strategy through a manipulated exchange rate or structural shortcomings, such as the absence of an adequate social security net that results in excessive private savings. He also points out that the IMF has had little success in persuading countries to reduce their 'bad' imbalances, and there were few clear warnings from the IMF in advance of the crisis. The IMF focussed almost exclusively on the threat of an exchange rate crisis resulting from a pullout from dollar assets, leading to a disorderly decline in the dollar and a spike in interest rates. It did not look at how these imbalances were linked to the systematic risks building up in financial systems.

These arguments suggest the need to examine differences in stages of development, demographic patterns, market failures and other structural shortcomings and how these work through saving and investment patterns and the financial system leading to persistent external imbalances. Hence, imbalances are only symptoms that should be used as a diagnostic tool to identify the underlying causes of the imbalances. The research challenge is in disentangling the causes of imbalances between structural factors and policy distortions.[13] One body of literature[14] suggests that domestic policy distortions played a major role in driving global imbalances in the run-up to the crisis.

What has the G20 done to rebalance global demand and what needs to be done in the future? First, the G20 spent a lot of time identifying quantifiable targets for measuring 'excessive' imbalances. However, it failed to identify the driving force behind the imbalances. And the domestic situations in G20 countries and the sources of imbalances differ widely. As such, policies should be tailored to individual country circumstances, especially the underlying distortions, to anchor the G20 objective of strong sustainable and balanced growth. For example, fiscal consolidation, appropriately timed in advanced economies to reduce the persistent deficits and create fiscal policy space, should be complemented by revival of internal demand in surplus countries to support domestic and global growth.

However, this is easier said than done. A number of concerns remain in rebalancing global demand. First, convincing policymakers to achieve a global public good such as reducing imbalances, especially when a growth model is working fairly well—as in China—would be a difficult task. Here, the G20 may play a decisive role through its peer review process identifying domestic policies for countries that are good for sustaining domestic growth and also for resolving global imbalances. Building on these ideas, *Emil Stavrev* notes that the IMF sustainability report identified seven systemic members as having "moderate" or "large" imbalances that warranted more in-depth analysis. Sustainability assessments indicate that external imbalances have been driven primarily by saving imbalances: i.e. saving in major advanced economies has been too low, and too high in key emerging surplus economies. He argues therefore that policymakers need to continue their efforts to further promote such dual rebalancing which involves a "hand-off"—or trans-

[13] A closer look at the external imbalances in the run-up to the crisis shows that sources vary widely across seven systemic economies (the countries that account for 5 % or more of G20 GDP are China, France, Germany, India, Japan, UK and USA). A variety of structural factors reflecting country circumstances have driven savings and investment behaviour: low private and public savings, imbalances between tax revenues and spending commitments and resistance to raising taxes in the USA; low savings in the UK; high savings and over-investment partly reflecting the distortions in the financial sector in Germany; scores of factors including high savings, structural imbalances between tax revenues and spending, declining productivity and a shrinking labour force in Japan; despite high private savings, low public savings and tax revenues, and high spending commitments in India; and exceptionally high private savings and investment, partly inadequate social safety nets, restrictive financial conditions, under-valued exchange rates, subsidized factors of production, limited dividends and lack of competition in product markets in China.

[14] For example, see Blanchard and Milesi-Ferretti (2009).

fer—from public to private demand-led growth in major advanced economies. Dual rebalancing also requires a shift from growth led by domestic demand in major advanced deficit economies towards external demand and vice versa in major emerging surplus economies.

What about emerging markets? In his note, *Takuji Kinkyo* argues that in response to the Asian financial crisis of 1997–1998, crisis-hit Asian countries abandoned *de facto* dollar pegs and officially claimed to adopt floating exchange rate regimes. However, as widely recognized in the literature, there is a discrepancy between *de jure* and *de facto* exchange rate regimes. Kinkyo shows that while China's current account surplus has declined sharply from the peak level before the global financial crisis of 2008–2009, there is evidence that the renminbi still remains substantially undervalued. In particular, he argues that the renminbi is not appreciating fast enough to match the pace of changes in underlying fundamentals, notably the rise in productivity and the accumulation of net foreign assets. The renminbi could, however, become substantially undervalued once global demand begins to grow faster.[15]

In their note, *Jong Kook Shin* and *Chetan Subramanian* argue that global imbalances are not a new phenomenon and have been around for the past three decades. What is important is that the magnitude of the imbalances in the 1980s was relatively modest in comparison to the imbalances immediately prior to the crisis. In addition, the external deficits of the USA and other advanced countries in the 1980s were largely funded by other advanced countries, such as Japan and Germany. In contrast, more recently the imbalances of the advanced countries have been funded by emerging markets.

The authors argue that this pattern highlights one of the important causes for the global financial crisis, namely the demand for risk-free assets which partly reflects poor levels of financial development in the EMEs. The authors argue that this explains the *Lucas Paradox,* where capital flows from the EMEs to developed countries (Lucas 1990).

[15] Another factor is petro-dollars. To quote the Economist, "[t]he biggest counterpart to America's current account deficit is the combined surplus of oil exporting economies which have enjoyed huge windfalls from high oil prices. This year the IMF expects them to run a record surplus of US$ 750 billion, three fifths of which will come from the Middle East. This amount will dwarf China's expected surplus of US$ 180 Billion. Since 2000, the cumulative surpluses of oil exporters amounted to over US$ 4 Trillion, twice as much as that of China" (The Economist 2012). Little attention has been paid to this, as petro-dollars do not show up in international reserves but go into sovereign wealth funds. This does not help the recovery of global demand. This could be corrected partly by exchange rate movements and partly by spending, especially on domestic consumption.

4 Financial Sector Regulation

Participants in the conference recognized that the financial sector has been a big source of shocks to the global economy.[16] Financial sector regulation has also been at the heart of G20 initiatives from the first Leaders' Summit: the G20 succeeded in agreeing on Basel III capital, leverage and liquidity standards, expanding the regulatory perimeter to include systemically important financial institutions (SIFIs), macro-prudential tools and regulation of the shadow banking system.

These reforms have triggered a debate on several questions: were the reforms still too little or did they overreach and excessively impede financial markets? Is the focus on achieving financial stability at any cost? While it is now widely recognized that pre-crisis financial regulation was too lax, is financial regulation after the crisis leading to credit rationing? How can economies reform the financial sector without stifling it? How do countries coordinate financial regulation across jurisdictions; and is it reasonable to have coordination when economies are at different stages of economic and financial development? An area that is of particular interest to India is whether raising fresh capital to comply with the new Basel III norms for Indian banks will be a challenge amidst a slowing economy.[17]

The crisis has also challenged the intellectual foundations—efficient markets, self-regulation, market discipline and financial innovation—that prevailed prior to the crisis. Light touch regulation and supervision were thought to be adequate as markets were efficient in accurately measuring risks and allocating them optimally, and financial innovations were considered to have improved risk management. But the crisis changed these perceptions. One lesson from the crisis is that financial stability is not independent of macroeconomic stability, or the latter independent of the former. Participants in the conference felt that the crisis highlighted many gaps in the regulatory and supervisory framework, including:

- Failure of regulatory policies, particularly capital adequacy and liquidity standards and disclosure requirements to assess risks
- Pro-cyclicality of capital standards

[16] In a May 3, 2013 entry to the IMF direct (blog), David Romer of Berkeley points out that financial shocks are not rare, and should be thought as being closer to commonplace rather than being considered as exceptional events. He suggests that in the past 30 years in the USA, there have been six occasions in which financial developments have posed important macroeconomic risks: the Latin American debt crisis, the 1987 stock market crash, the savings and loans crisis of the late 1980s and early 1990s, the Russian debt crisis of 1998, the dot-com bubble bust of the late 1990s and early 2000s and the housing crisis and financial meltdown of the GFC starting in 2008. See http://blog-imfdirect.imf.org/2013/05/03/preventing-the-next-catastrophe-where-do-we-stand/.

[17] One of the fears of current reform initiatives is that it may lead to credit rationing. Domestically, the most affected segment would be small- and medium-sized enterprises, while globally it would be EMEs, especially trade credits to EME firms. Similarly, countries where a home-grown banking system is absent would get affected most as globally active backs deleverage. This would call for targeted reforms—special provisioning—rather than general relaxation regulatory standards. Second, much of the G20 debate on financial regulations reflects problems of the USA and Europe and is not necessarily relevant for EMEs.

- Too-big-to-fail problems and associated excessive risk-taking behaviour by financial institutions
- The absence of macro-prudential tools
- The position of shadow banking outside the regulatory perimeters
- Failure to appreciate potential risks associated with innovation, compensation structures and associated misguided incentives, the systemic importance of non-banks and the importance of the relationship between banks and non-banks
- Too much reliance on credit rating agencies
- Corporate governance failures

In the lead chapter to this section, *Stephen Pickford* takes stock of many of the above issues and argues that an important aspect to consider is the extent and form of financial sector reforms already undertaken, and the variable impact such reforms may have on economic activity in countries that are at different stages of economic and financial sector development. He argues that in political economy terms it was necessary for governments to tighten regulation in order to address the regulatory shortcomings exposed by the crisis, which required exceptional levels of support and financial resources provided to banks and other financial institutions. Further, malpractice and misbehaviour in private financial institutions has added political pressure for tighter regulation, compounding the pressure already resulting from the high cost of public support for banks during the crisis. Overall, he considers that while the jury is still out on the cost and benefits on a variety of regulatory reforms, there are good political economy reasons for completing the current regulatory programme. This is based on the view that while reforms to address the shortcomings that led to the last crisis may not prevent future crises, at the very least they should prevent a repeat of the last one.

In his note *Jae Ha Park* argues that Asian financial systems have been relatively unaffected by the global financial crisis (GFC) and the ongoing eurozone crisis, reflecting sound balance sheets, prudent risk management and modest exposure to toxic assets. He notes that this strength of the Asian financial system is due to its sizeable non-banking financial firms. In addition, large foreign exchange reserves have provided a cushion against volatile capital flows in most cases. He notes, however, that requirements under Basel III may impose an excessive burden on some emerging Asian economies. Basel III and related supervisory and regulatory measures, which were designed from the perspective of the experience of developed economies during the GFC, may not necessarily be applicable to Asian emerging market economies.[18]

[18] Many participants felt that regulatory concerns of EMEs are different given their developmental needs. The regulatory philosophy in most of the EMEs, especially in Asia (and India), is different—regulators pay close attention and capital and liquidity standards are high. Asian regulators also have used macro-prudential policies—administrative guidance to limit bank-credit growth, real estate loan caps, etc.—which provided a cushion against the crisis. Hence, reforms proposed to address weaknesses in advanced country financial markets may not be applied to EMEs. Though capital and liquidity standards of Basel III are easily achievable for Asian countries, strengthening regulatory capacity and data requirements for implementing Basel III may impose an excess burden. However, it should be noted that international standards such as Basel rules are meant

In his note, *Berndt Spahn* looks at more recent proposals for reorganizing banking supervision in Europe and the euro area in particular. He argues that while the entire gamut of financial sector reforms—ranging from reforms that enhance the quality and quantity of capital, liquidity and leverage ratios, regulating OTC derivatives, identifying systemically important financial institutions and better macroprudential regulations—will impose new costs and lead to a restructuring of activities, they will not jeopardize the functioning of the financial industry.

Anand Sinha argues in his note that the recognition of the role of systemic risk and the importance of financial stability are the major lessons from the crisis. While there are arguments for both supporting and opposing the new regulations, each has its own merits. The answer therefore lies in striking the right balance to ensure that the new regulations achieve their objective of strengthening the resilience of the financial system while at the same time not adversely impacting on economic growth and the efficiency gains from financial innovation.

In the discussion, many participants felt that while forward-looking provisioning and cross-border resolution mechanisms are being introduced, considerable efforts are still required to identify models or metrics to measure systemic risk and its interaction with the financial system and real economy to effectively use macroprudential policies for smoothing credit cycles and achieve financial stability. Financial sector reforms have triggered debates over the impact on bank lending and economic growth. It was acknowledged that high capital, liquidity and leverage standards, and restrictions on certain activities for banks have arguably reduced lending to the private sector and stifled innovation, which depresses growth. Sceptics of financial sector reform typically question the ability of regulators to manage the more intrusive regimes. They also show, using historical data, that simple and market-based rules substantially outperform complex rules such as the risk-based Basel approach. On the other hand, the proponents of financial sector reforms argue that the damage unleashed by the crisis is massive, and hence the expected benefits of financial stability outweigh the costs of regulation. Further, given that financial markets failed to assess risk and there was fraud and manipulation, policymakers and the public at large lost trust in the self-regulation of financial markets. The discussion demonstrated that the debate is still inconclusive.

The participants in this session highlighted the need for cooperation in the implementation of standards and the importance of consistent implementation across regions so as to mitigate regulatory arbitrage. These standards are global and non-binding. The G20, however, has entrusted the Financial Stability Board (FSB) with developing a coordination framework for monitoring implementation at national level.

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for internationally active banks. Countries have a large leeway to implement them as they deem fit—for example, India has proposed to apply it fully, while Japan and the USA have opted it for only the internationally active banks. Finally, an important issue that arises here is the concern over the rapid growth of bank credit. This may be a misleading indicator of "stress" since in EMEs, bank credit is partly driven by more financial inclusion. Universally stringent capital standards (such as Basel III) may disproportionately affect EMEs as globally active banks would reduce their exposure to EMEs to meet new stringent capital standards. Further, if the new standards are implemented in EMEs, this would make development financing and financial inclusion difficult.

Indeed, financial reforms received top billing in the first three summits and have continued to be an important issue in the later summits. The successful implementation of financial reforms would highlight the success of the G20 as a global coordination mechanism. Many considered that rolling back the agenda was not an option.

To summarize, participants felt that several messages can be drawn for the G20's financial regulatory reforms. In the pre-GFC period, financial regulation was not equipped to identify risk concentration and permitted flawed incentives. Macro-policies also failed to take into account the build-up of systematic risk. Hence, it is crucial to fully complete and implement the existing commitments to tighter regulations. However, it is important to take into account the situation of emerging markets, including those in Asia. If there are sector-specific problems, especially pertaining to credit and/or EMEs, then sector-specific and EME-specific solutions must be framed. There may also be a need to consolidate the agenda and focus on implementing existing reform initiatives. This would give regulators and supervisors some time to reflect on what form of regulation and supervision works best in practice. Other broad questions that emerged included what is the optimal FSB–G20 relationship, and how should we assess progress, particularly the trade-off between the safety of the financial system and economic growth.

5 A new framework for reforming the International Monetary System

The G20 agenda for reforming the international monetary system (IMS) includes managing global reserve currencies, managing excessive capital flows and volatility, and providing a global financial safety net. Participants felt that the G20 has made little progress on developing a comprehensive multilateral framework for reforming the IMS. Some relevant questions raised in this session were:

- Is the IMS fundamentally flawed?
- Has the evolution of the IMS kept up with changes in the global economy?
- Will fundamental changes in the global economy make the IMS more multipolar?
- Has the G20 provided a concrete proposal for reforming the IMS?
- What role can global financial safety nets play in mitigating balance of payment crises and reducing IMS-induced global imbalances?
- What is the role of macro-prudential policies in mitigating the deleterious effects of volatile capital flows?

The IMS has evolved from the gold standard to the Bretton Woods arrangements of fixed and adjustable exchange rates (since 1971 when the gold standard was abandoned), and finally to the current system of broadly floating exchange rates. A key feature of the current IMS is that it requires a liquid international asset of stable value (i.e. a reserve asset, which since the demise of the gold standard has been the US dollar). There are, however, several symptoms of instability in the current IMS.

This is evidenced by (1) routinely recurring crises in the post-Bretton Woods period marked by persistent current account imbalances, (2) volatility in capital flows and currency values and (3) a sizeable build-up in international reserves in key emerging economies, which approached $6 billion or over 25 % of global GDP on average in 2008 (Ghosh et.al. 2012).

The root causes of this instability can be traced largely to the following:

- Inadequate global adjustment mechanisms. There are no mechanisms for burden sharing across countries and, as such, the system is prone to inconsistencies and externalities.
- The lack of a global oversight framework for cross-border capital flows. The higher volume of cross-border capital flows creates complex interdependencies, and a universal framework that addresses cross-border capital flows is lacking.
- No systemic liquidity provision mechanism. The size of the collective safety net is inadequate and there is no systematic mechanism to provide liquidity at the global level.
- Structural challenges. There are concerns about a dominant national currency-based system which provides "exorbitant privilege" to the reserve currency issuer. Further, this creates a deep dependence for the rest of the world on the reserve issuer's domestic policies. Furthermore, it raises the possibility of an asymmetric adjustment to imbalances.
- There is a need to accommodate the changing core and to generate the necessary supply of safe assets.

In the lead chapter, *Jyoti Rahman, Ewa Orzechowska-Fischer* and *Redom Syed* suggest that while the current IMS needs reforms, a completely new system is not required. They note that in the 2012 Los Cabos summit, the G20 Leaders further supplemented the IMF NAB (New Arrangements to Borrow) and quota resources with bilateral loans worth more than US$ 456 billion. This has bolstered the IMF's lending capacity. In response to the crisis, the Fund also created a flexible credit line (FCL) and a precautionary liquidity line (PLL) aimed at bolstering market confidence and alleviating balance of payment risks for countries with strong economic fundamentals. However, the GFC highlighted significant weaknesses in the IMF's surveillance methods. A review of surveillance led to major improvements in the surveillance framework with a strengthened focus on spillovers as opposed to an earlier emphasis on exchange rate policies as a primary contributor to external imbalances. The authors also note that while the IMF has been undergoing a set of governance reforms aimed at increasing the representation of emerging markets, further reforms are needed to make the IMF governance structure reflective of changing global realities, and that these reforms should lead to a substantial shift in the IMF quota shares towards the dynamic EMDCs and a change in the IMF quota formula.

In similar spirit, *Emil Stavrev* argues that while the current IMS has survived for over 40 years and has under-pinned strong global growth and increasing integration, it has also exhibited many symptoms of instability. His note summarizes the key problems facing the IMS and discusses potential reforms. The avenues for reform can be found first in strengthening policy collaboration in the core and pe-

ripheries through the G20 mutual assessment process (MAP). There should also be a strengthening of IMF surveillance and integration of bilateral and multilateral surveillance. This needs to be further complemented by the monitoring and management of global capital flows. Further work is needed to focus on macro-prudential and capital flow management measures. Finally, the creation of a strong global safety net will be necessary to fully mitigate the above-mentioned instabilities. However, to ensure the success of this plan, it will be important to navigate an orderly and gradual transition to the stronger governance system. Participants in the session recognized that there is an asymmetry in the G20s reform agenda, with a focus on reviving global growth, reducing unemployment and dealing with social issues, while longer-term issues—especially the periodic tendency of instability in the IMS—have not been adequately addressed.

Gurbachan Singh, in his note, focuses on credit lines more specifically. He argues that credit lines (CLs) can serve as safeguards against the pure *sudden stop* of capital inflows into otherwise 'solvent' economies. Since a sudden stop implies a liquidity crunch, it may be difficult for public authorities to raise funds internationally *ex-post* once a sudden stop has occurred. In this context, an *ex-ante* CL gives an option to borrow in the event of a sudden stop. Credit lines can be put into two categories: those that need to be backed by some reserves or liquid assets and those that do not need to be backed by reserves. He proposes that the IMF could serve as a mediator between central banks that use swap credit lines for mitigating a currency crisis. This role is different from the current role of the IMF as a provider of liquidity.

Participants also observed that the objective of the Special Drawing Right (SDR) becoming a "principal reserve asset" was unlikely in the foreseeable future. Overall, the current IMS needs a broader dimension including stronger surveillance, particularly over exchange rate policies, benchmarks and members' obligations, along with more work on global liquidity, the role of the SDR and improved governance arrangements. The IMF has taken a number of initiatives to strengthen its surveillance, including the adoption of an Integrated Surveillance Decision (ISD). But while steps have been taken to improve the analysis and coverage of IMF surveillance, the ongoing challenge is for the IMF to have greater traction with its advice in terms of influencing countries' policies. There is also a need for shared understanding of liquidity requirements by the IMF, Bank for International Settlements (BIS) and the Financial Stability Board (FSB). As regards the use of the SDR as a reserve asset, an international unit of account and an incentive to improve the workings of the adjustment process, further consideration should be encouraged. The composition of the SDR basket should be kept under review and modified as required to reflect the relative importance of economies in international trade and financial transactions.

With regard to national monetary policy, one implication of the use of unconventional policies, such as quantitative easing (QE), is that other countries, particularly EMEs, may lose competitiveness through no fault of their own. No central bank is

held domestically accountable for the effect it has on other economies. The use of capital controls remains an important issue for the international community.[19]

Finally, the crisis has provided the trigger as well as the opportunity for reforming the IMS. Positive gains from global economic integration post-Bretton Woods are now under threat as there is an increased risk of instability, retreat to protectionism and competitive depreciations, leading countries to strengthen national reserves and regional reserve pools.

6 Capital Control Policy and Emerging Market Economies

Many participants felt that capital flows are mostly beneficial as they finance productive investment, diversify risk and smooth consumption. But sudden and excessive inflows cause various macroeconomic concerns and financial stability risks such as currency appreciation and asset price bubbles. Participants in this session felt that there were three major issues regarding the use of capital controls:

- The choice between capital controls and prudential measures
- Ensuring capital controls do not substitute for appropriate macroeconomic tools
- Ensuring prudential measures are non-discriminatory

New avenues for future research would include developing a framework for applying the above policy measures for different kinds of capital flows (debt, FDI, etc.) which could require different policy measures to be taken up by the recipient and source countries, and whether it is useful to draw upon the policy measures taken by developed nations and apply them to EMEs whose situations and circumstances may be very different from advanced economies.

In the lead chapter, *Abhijit Sengupta* and *Rajeswari Sengupta* discuss some of the challenges that have emanated from India's increased integration with global capital markets. India's experience with capital flows which remain volatile has complicated monetary and exchange rate management. The authors argue that India has adopted a multiple instrument approach that includes active management of capital flows, especially volatile short-term and debt flows; a moderately flexible exchange rate regime with the RBI intervening with sterilization to prevent excessive volatility and active foreign reserve management. The authors calculate the exchange market pressure (EMP) index in India and track its evolution over the last couple of decades. They also evaluate the extent to which the EMP index has been influenced by major macroeconomic factors and conclude that the EMP has exhibited a great deal of fluctuation during the period 1990–2010. This is due to global and domestic events and has primarily been affected by changes in the trade balance, portfolio equity inflows and stock market fluctuations. In sum, India's ex-

[19] See the Landau report on global liquidity prepared by BIS at the behest of G20 (BIS 2011).

perience in negotiating the macroeconomic "trilemma"—monetary independence, exchange rate stability and capital account openness—given its integration with global capital markets during the last two decades, is commendable. India has opted for the middle ground and has balanced all three objectives by buffering the trade-offs through reserve accumulation.

In his note, *Atish R. Ghosh* draws attention to ongoing research with colleagues in the IMF's Research Department on the use of capital controls in the face of inflow surges; the nexus between capital controls and macro-prudential measures; and multilateral aspects of managing the capital account. His note summarizes this work. He argues that the policy toolkit for addressing financial stability risks could possibly include prudential measures and capital controls that may or may not discriminate between residency and currency. These risk-mitigating policies have all been undertaken by most countries at some time. But this raises the question of choosing between prudential measures and capital controls against financial stability risks. Prudential measures that are non-residency based (i.e. applied to the domestic banking system, and based on currency rather than residency) should be used when the flows come through the economy's financial/banking sector. The cases where flows come through the non-banking or non-financial sector should be handled with the use of capital controls. There are also issues of multilateral cooperation which are of concern to the G20, i.e. how policies should take account of multilateral considerations and mechanisms through which spillover impacts are recognized and worked upon. In addition, there is a renewed interest in international policy coordination arising from imbalances between savings (current account surpluses) and borrowing (current account deficits). Other issues include the possible tools for capital account management, the effects of quantitative easing in advanced economies on capital flows to emerging markets and the role of fiscal and monetary policy as a stabilization tool in emerging markets. Capital controls that are good for one country may not be necessarily good for others.

In the last few years, the world economy has experienced dual-track growth, with strong growth in Asia contrasting with below-trend growth in most advanced economies. There is an interesting contrast between the last few years and the pre-1997 period in which *excessive investment* in the Asian economies was funded by short-term debt denominated in foreign currency, resulting in both a maturity and foreign currency mismatch. Now, the Asian region has *excess savings.* In general, Asia has been able to weather the 2008 crisis. FDI inflows have been strong and have continued to be strong during the GFC. This is because most FDI has been attracted by growing production networks in East Asia. Another factor has been domestic demand-driven growth, which is an attractive factor for FDI. Equity flows are also on the rise: many Asian economies have undertaken financial sector reforms which supports equity flows. Motivated by this, *David Kim* asks whether monetary union in Asia (ASEAN 5 plus three) is a possibility. He notes that the region is far more heterogeneous than both the European Union and Mercosur in terms of per capita income, geographical proximity, industrial structure, political proximity and institutional institutions. Another relevant factor is that these countries are at varying stages of economic development as evidenced by the composition of industrial

structure within the region. However, the significant growth in intra-industry trade and foreign direct investment in recent decades has stimulated discussion of closer regional economic integration. To address this, *Kim* notes that a key criterion is the synchronization of business cycles (also referred to as the symmetry of shocks) because the cost of losing an independent monetary policy would be small. He concludes that for regional shocks, several countries within East Asia have uniform responses. This points to the potential benefit of a common macroeconomic policy if the regional shocks constitute a significant proportion of all disturbances.

In sum, many of the participants felt that capital controls are an open field, with the orthodoxy being challenged. Several interesting questions and observations relating to capital controls include:

- What drives capital flows (pull factors or push factors)?
- The composition of capital controls matters (equity-type liabilities versus debt-type flows which tend to be highly volatile).
- The focus should be on gross flows. Net flows are more important for macroeconomic management, but gross flows are more important for financial stability.
- What are the factors affecting gross flows (global factors versus contagion and debt flows)?
- Is there a case for capital controls—what is the empirical evidence?
- Do capital controls help navigate through the impossible trinity?
- What is the appropriate dichotomy in the use of instruments for dealing with monetary policy and macro-prudential policies?
- The need for flexibility and pragmatism (rather than textbook orthodoxy).

Participants also felt that the policy toolkit to address macroeconomic challenges could include allowing the external balance to move towards the medium-term multilaterally consistent equilibrium value. The EMEs following a floating exchange rate would allow the nominal rate to appreciate. The “peggers” would not engage in any sterilized intervention. Other options include

- Accumulating reserves for country insurance
- Lowering interest rates and tightening fiscal policy
- Using capital controls/prudential measures.

7 Austerity and Growth.

This section had two objectives: first, to re-visit the austerity versus growth debate in light of the USA, eurozone and emerging market experiences in the post-financial crisis period; and second, since infrastructure spending is typically cut in fiscal austerity programmes, what does austerity imply for long run growth in national economies. The debate on austerity versus growth is deeply divided. An open research question is whether there are conditions under which contractionary fiscal policy can be expansionary. Further, if short-run stabilization is not the exclusive

domain of monetary policy, what fiscal tools are required. In the lead chapter, *Alok Sheel* argues that any overall assessment of the G20 must focus on two metrics: its success as a model for global economic governance and the welfare gains from the globally coordinated response orchestrated by G20 central banks and Leaders after the GFC. He notes that—in one instance—the G20 has not delivered on macroeconomic policy coordination because of the introduction of "expansionary fiscal contractions." This leads to a host of related questions: if fiscal multipliers are potentially high, why is the US recovery not more robust? Could this be because of the fiscal mix? He suggests that Ricardian Equivalence may come in the way of translating additional income into expenditure. In a recession induced by a financial crisis, tax cuts may be less effective than direct government expenditure in stimulating the economy.

He argues that one area that needs more attention by the G20 is the lack of public investment in infrastructure in developing countries. Infrastructure investment could help enhance the effectiveness of macroeconomic policies during a downturn through various channels: first, it would stimulate the economy by creating more jobs and induce household spending; second, it would complement monetary policy transmission channels; third, it would address the instability in the global economy by rebalancing global demand as infrastructure investment is import intensive; and fourth, it would help rebalance demand from the public sector to the private sector. Emphasizing infrastructure investment in G20 deliberations would also calm the markets as they would be convinced of at least one source of growth in global demand. He recommends accelerated financing and implementation of public investment projects in developing economies—which would hasten both global and internal rebalancing, with the associated demand for capital goods creating jobs in advanced countries. He also argues that one area where there is scope for cooperation is coordinating fiscal policy. The task of fiscal re-structuring is complicated by the fact that collective austerity leads to a vicious feedback loop. An immediate priority for fiscal policy is therefore the composition of adjustment: particularly whether the adjustments are growth friendly and not overtly harmful in the short run.[20]

In their note, *Denis Medvedev* and *Smriti Seth* argue that there are mixed views on the role of fiscal consolidations in reducing both public debt and simultaneously reducing the output gap. The proponents of fiscal consolidation argue that a credible consolidation plan would imply a reduction in expected future taxes, and hence an increase in expected future income, which would lead to an increase in current consumption. Hence, fiscal consolidations could be expansionary. In addition, spending cuts would work through the labour market channel as well: it would reduce wages, increase profits, which in turn would increase investment and stimulate long-term growth.

[20] In normal times, sovereign borrowing costs are positively associated with public debt. During a crisis period, however, funds tend to move from high-risk assets to risk-free sovereign bonds. Thus, though there is an increase in the fiscal deficits, there will be a fall in the Treasury bond yields in major developed countries. This fiscal space, if utilized, can stimulate growth which will be a key factor for stimulating growth, and hence fiscal consolidation in the medium to long run.

On the other hand, the proponents of fiscal expansion argue that when expansive monetary policy and private investment cannot pick up the slack, the government should step in. The stimulus can pay for itself, as economic activity picks up, as will tax revenue. Further, a contractionary fiscal policy will work for a country through the export channel if the global economy is growing. If there is a synchronized downturn in many countries, as is the case now, austerity would suppress global demand and aggravate the downturn. However, the effectiveness of stimulus in bridging the output gap depends on the stage of the business cycle and the speed of adjustment of the markets. Also, there is a role for complementary policies, especially monetary policies and supply-side policies.

What should governments do? While it is easy to propose cutting unproductive expenditures and increasing productive expenditures, this is difficult to do in practice. It is not easy to distinguish productive expenditure from unproductive. However, going by the literature, spending on health, education and infrastructures is productive, which would in turn increase productivity in the private sector. Further, how such spending is financed, and what margins are distorted, the composition of government spending would have implications for the effectiveness of a stimulus package.

A policy-induced depression in some sectors should be corrected by reducing subsidies and/or increasing tax in the other sectors—for example, a policy-induced repression in the manufacturing sector in India could be corrected through taxing the agricultural sector or at least by reducing subsidies to the agricultural sector that would tilt the terms of trade in favour of manufacturing. Similarly, reducing wasteful agricultural subsidies in the European Union could free valuable fiscal space. However, these are politically contentious.

Shankar Acharya argues that over the past 30 years fiscal austerity has been notable by its absence in India. The combined deficit of central and state governments has typically been in the range of 7–10 % of GDP, except for 5 years, two in the mid-1990s and three in the mid-2000s. However, while the two best periods of economic growth in India, 1992–1997 and 2003–2008, *have* been associated with significant fiscal consolidation, periods of high fiscal deficits *have not* engendered high growth. Further, the persistence of the high fiscal deficits beyond 2008/2009, while contributing to India's economic resilience in 2008–2010, also helped fuel the high inflation of the post-crisis years, reduced domestic savings and helped induce the worrisome widening of external deficits. The need for successful fiscal consolidation in India therefore remains strong. He also suggests that because India's fiscal policies in the last 25 years cautions against accepting a uniform policy paradigm for all nations at all times on issues of fiscal policy, the ongoing industrial nation debate on austerity versus stimulus may have little practical relevance for India's current fiscal priorities.

Acknowledgement We are deeply grateful to Isher Ahluwalia, Parthasarthi Shome, Rajat Kathuria and members of the ICRIER G20 team for their support related to this volume.

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