

What G20 leaders must do to stabilise our economy and fix the financial system

Edited by: Barry Eichengreen and Richard Baldwin

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A VoxEU.org publication

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Introduction

The global economic, financial and political situation has reached a dangerous point. Governments and central banks have staunched the bleeding in their financial systems for the moment by nationalising banks, guaranteeing their liabilities, and back-stopping markets in debt securities. But they lack an exit strategy from the awkward position in which they now find themselves. Nor is it clear that they are prepared for the next round of financial difficulties that will follow as the crisis spreads from Wall Street to Main Street and from advanced countries to emerging markets. There is no agreement on what to do about the global economic downturn. Economically and financially there is a clear sense of things spiralling out of control again.

Turning from the crisis to the reform agenda, there is no consensus about how to prevent a recurrence. Everyone agrees on the need to strengthen supervision and regulation, but there is no agreement on how to go about this. Everyone recognises the threat posed by large cross border institutions and banks that are too big to save, but there are few practical ideas for solving these problems.

Finally, this is a difficult political moment. The US is in the interregnum between administrations. The EU is approaching another periodic change in its presidency; once again it is not clear who to phone when you want to talk to Europe.

The world cannot wait, but the meeting presents dangers as well as opportunities

These are not propitious circumstances for a G20 meeting to discuss a new international financial architecture. Yet the condition of the global financial system and the world economy is too delicate to wait. The need is urgent for substantive steps to stabilise the global economy and reform the financial system.

But there is also a danger attached to this meeting. Leaders come exceptionally ill prepared. It is not as if their staffs have had months to craft thoughtful background notes. An empty declaration – ‘we assembled G20 heads of state commit to stabilising our economies and strengthening the regulation of our financial systems through ongoing collaboration,’ like that issued by the G7 in October – will only demoralise the markets. Signs that our leaders are bereft of ideas and unable to agree on priorities will tell investors that the future will resemble the recent past. The meeting will then do damage rather than repair it.

The purpose of this book

Alert to this danger, we have assembled leading economists from the G20 countries to provide proposals for the meeting. Our contributors identify four priorities.

- Use additional triage to staunch the financial bleeding and fiscal stimulus to get the patient's heart pumping again.
- Strengthen existing institutions.

- Start thinking outside the box.
- Do no harm.

There is unanimity on the first point. Governments need to move ahead with the utmost urgency in recapitalising banks, guaranteeing cross-border bank claims, restructuring nonperforming assets, and extending financial support for crisis countries. They need to coordinate their initiatives. They need to move fast. There is no mystery about how to go about this.

Similarly, there is an urgent need for immediate, substantial, internationally coordinated fiscal stimulus. Here China has shown leadership, and other countries should follow. Leaders from different countries may object that their national circumstances are special – that they cannot or should not participate. These objections cannot be accepted. The argument here – again on which there is unanimity – is not for one-size-fits-all fiscal expansions but for fiscal actions tailored to the circumstances of the individual country and taken with a view toward the impact on the rest of the world. Commitments should be announced on November 15th.

On the second point, strengthening existing institutions, there is again unanimity on the need to augment IMF resources immediately so that the institution has adequate firepower. There are a variety of ways of doing this – a new SDR issue, borrowing on the market, recycling the resources of reserve-rich emerging markets through the Fund – any of which would do the trick. But there is absolutely no dissent from the view that it is essential to take action on this problem now.

Similarly, there is unanimity on the need to strengthen existing arrangements for global governance. The authors here have a number of alternative visions: reconstitute the G7, rely more on the G20, create an entirely new body. But there is agreement that the problem can no longer wait. Similarly, there is complete agreement on the need for fundamental reforms of IMF governance to restore the legitimacy of the institution. As our contributors describe below, it is transparently clear what needs to be done.

On the third point – think outside the box – several authors argue for new approaches to the regulation of large cross-border financial institutions, such as an International Bank Charter, a World Financial Organisation, an International Insolvency Mechanism for financial institutions, or even a single global regulator. None of these proposals will come to fruition on November 15th. But it is essential to start discussing them now.

Finally, doing no harm means not throwing the baby out with the bathwater. It means not clamping down so hard on financial institutions and transactions that they become incapable of providing intermediation services or innovating. It means not responding to deep recession with protectionist measures that beggar one's neighbours and destroy the world trading system. It means not creating and administering a new IMF liquidity facility in such a way that it undermines confidence in countries that were denied access. Avoiding such actions are concrete commitments to which G20 leaders can agree on November 15th. Temporising would be a catastrophic mistake.

These pieces were written for a November 9th deadline and edited into their present form by Team Vox; we especially thank Pierre-Louis Vézina, Anil Shamdasani, Nicole Hunt and the CEO of CEPR, Stephen Yeo for their incredible support.

Barry Eichengreen and Richard Baldwin
Berkeley, CA. and Geneva
11 November 2008

Quick action for the real economy; sober reflection for financial regulation

Alberto Alesina and Guido Tabellini

Harvard University and CEPR; Bocconi University and CEPR

Regulatory reforms are surely needed, but this is not what G20 leaders can or should decide at this meeting; hasty new regulations could easily make things worse. The urgent need is for coordinated action to stimulate the global economy with fiscal and monetary measures. Allowing for varying national situations is essential.

The worst part of the financial crises seems to be over. While regulatory reforms are needed for the future, they are not urgent now. Let's think calmly and let's not rush into punitive regulations that would interfere with a smooth functioning of financial markets for decades to come.

Containing the real-economy damage

On the other hand, time is of the essence when it comes to containing the real effects of this crisis. In a normal business cycle, it is important not to overreact with monetary and fiscal policy. Gradualism in monetary policy and a fiscal policy that allows automatic stabilisers to do their job are enough.

Today we need something more aggressive. But we should not forget the "long and variable lags" emphasised by Milton Friedman. Excessive policy activism may have unintended consequences stemming from the uncertain timing of effects. This message is important even today, but the exceptional gravity of the financial crisis and its worldwide nature argue against caution. A more proactive stabilisation policy is needed much more than in a 'normal' downturn.

Lower interest rates: gradualism is not an option

The first thing to do is to make sure that interest rates are as low as they can be without disrupting financial markets. Gradualism is not an option, and interest rates should be cut quickly and decisively. When the interbank market was shut down, cutting rates was almost ineffective. Today markets have slowly begun to work again, and lower interest rates would help.

The Bank of England seems to have understood the urgency. The ECB is behind the curve. Facing the possibility of deflation rather than inflation, the ECB should act more decisively.

Fiscal stimulus is needed

But in the current circumstances, monetary policy alone is not enough to support aggregate demand. Investment and consumption decisions are being postponed throughout the world, squeezed by the credit crunch and by self-fulfilling and hope-

fully overly gloomy expectations of a major contraction.

Aggregate demand needs to be sustained by fiscal policy. International coordination of some sort may be useful, although the specific policy tools ought to adapt to local conditions. Different countries have different needs, or to put it differently the optimal fiscal policy is different.

US-specific: Don't tax the rich – yet

President Elect Obama should not rush into increasing taxes on the upper middle class now; he should postpone the promised increases. A combination of tax relief for the lower middle class and spending on public infrastructure should be a priority, if only the proceeds could be disbursed quickly enough.

The new president will have to resist the temptation of increasing taxes now as his program announced. This is not the time to think about redistributing income and penalising the rich. This can come later since this is part of his mandate.

Now is the time to get the economy out of the recession. Populist and punitive policies against "the rich", the "financial markets" and so forth are unwise and should be scrapped. This will increase deficits but it is a price worth paying.

European-specific policies

Southern Europe needs to revamp unemployment insurance, making it more widely available. This would facilitate restructuring where needed, and it would make the likely rise in unemployment less burdensome. Normally it takes time to do welfare reforms, but now time is of the essence and these countries should proceed very fast. It may be too late but in any event this is a good policy despite its timing in relation to the current cycle.

Some European countries might also benefit from tax cuts on individuals and firms, although in the current uncertainty some of it might be saved rather than spent. Tax changes that reduce the wedge between gross and net wages would sustain employment and aggregate demand. Moreover, those countries that need more or better infrastructure should think about investing now, and fast.

Countries with high public debt cannot be reckless, however, and have to compensate the larger current disbursements with future spending cuts approved now. Pension reform is the obvious place to start. Failure to take offsetting action would be very risky, as financial markets are already pricing the possibility of 'runs' on countries with high public debt.

Avoid creating 'zombie' firms

There are also things that should not be done. One is to use the excuse of the financial bailout to save declining and unproductive industries, like the auto industry in the US, failing airlines like in Italy, or using public funds to provide targeted help to influential lobbies as announced by President Sarkozy in France.

This would prevent the process of creative destruction which invariably takes place during recessions, namely the reorganisation of supply according to efficiency criteria. Helping General Motors with public money would prevent more productive firms to come into the market, either in the auto industry or in other sectors.

In these exceptional circumstances, the support of the State is needed to sustain aggregate demand. But if successful, State intervention does not need to last very long. On the contrary, it would be a dramatic mistake if, over the medium run, the

heavy hand of the State were to replace the invisible hand of the market in directing resources to their best use.

About the authors

Alberto Alesina is the Nathaniel Ropes Professor of Political Economy at Harvard University and was Co-editor of the *Quarterly Journal of Economics* for eight years. He has published extensively in all major academic journals in economics, written five books, most recently *The Future of Europe: Reform or Decline*, MIT Press (2006). He is a CEPR Research Fellow.

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Coordinated responses versus identical responses

Refet S. Gürkaynak

Bilkent University and CEPR

The G20 leaders face two related but distinct problems: mitigating the economic damage of the global recession, and reducing the chances of future financial crises. The recession requires coordinated macroeconomic stimulus, but coordinated need not mean identical. The leaders should also discuss financial regulation, but a unified financial regulatory framework for the whole world is unattainable and undesirable. Leaders should waste no time on this; national financial systems vary too widely and some are already over-regulated.

The November 15th meeting of the G20 leaders should (and will likely) discuss three topics.

- The frozen, albeit slowly thawing financial markets;
- The impending recession, and;
- The precautions that should be taken to make sure such an episode is not repeated.

Two separate but related problems: crisis and recession

The liquidity crisis that has crippled financial markets around the world and the global slowdown in economic activity are two related but separate problems. The central banking community realised this early on and offered different remedies to each, in particular by coming up with creative ways of providing liquidity to financial institutions without relying solely on interest rate cuts. Going forward, it will be important to keep in mind the distinction between firefighting in financial markets and general macroeconomic policymaking.

Coordinated doesn't mean identical

The global nature of the crisis has increased (partly successfully) calls for coordinated action across countries. Leaders should be careful to distinguish between "coordinated" and "identical".

Macroeconomic stimulus

Now that the fire in the financial markets is somewhat doused, there is general agreement on the need for coordinated fiscal stimulus to dampen the effects of the global recession. Appropriate fiscal stimulus will be of different sizes and styles in different countries. While sending each household a check might be suitable for the US, many continental European and developing economies are better served by increased spending that addresses their structural economic problems. The reforms that address

the structural problems are often painful and costly; it would be virtuous to use stimulus-linked fiscal leeway to at least partly undertake them. Unfortunately, many governments may be fonder of spending more without addressing deep problems; "coordination" with the US will be a natural pretext.

The IMF, which has found new life with the current crisis, might be a natural candidate to at least monitor, if not help design, how each country undertakes its part of the global fiscal stimulus.

Developing countries, many of which will need IMF financial support and thus have to accept the attached conditionality, may end up behaving better than developed economies. Part of the IMF's job should be to call attention to countries that increase stimulus-linked government expenditures in a manner that leaves them deeper in debt but no better off in terms of their deep problems.

No country will forfeit its economic sovereignty and agree to IMF conditions unless they have to (i.e. need IMF money) but countries can at least be 'named and shamed' as part of the effort to avoid the fiscal stimulus turning into a free-for-all of wasteful projects.

Avoiding future crises

The G20 leaders' meeting is also a natural platform to discuss the precautions that can be taken to avoid experiencing a similar crisis again.

Trying to come up with a unified global financial regulatory environment will not work. Countries have different financial structures, needs and preferences. It would be best to avoid wasting time on a unified global framework. There are, however, some common lessons to be drawn.

An important lesson is that systemically-important financial institutions are no longer limited to deposit-taking banks. Implicit or explicit guarantees, and the associated monitoring and regulation, have to be extended to all financial institutions that are too big, too complex, or too crucial to fail.

In a similar vein, it may be worthwhile to attempt to establish common levels of government guarantees for deposits (or other liabilities of these institutions). This would prevent countries from trying to compete on guarantee-coverage in times of distress. While a unified global regulatory framework is infeasible, reaching consensus on broad guidelines may be possible. Here, once again it is important to realise that 'coordinated' does not mean 'identical'.

More regulation for all is not the answer

It is easy to think that one of the clearest lessons of this crisis is that more regulation of financial markets is needed. This is the wrong inference.

In some countries, notably in the US, better regulation of financial institutions and contracts would be prudent. Many other countries, however, already have financial regulation that is too tight; they should allow for more innovation in their financial industries.

The question leaders should ask themselves is: "Over the past century would it have been better to have lived under the US financial system and the real outcomes it helped create, or under our own financial system?"

In many continental European and developing economies the answer may be that the US financial system – with its faster growth in living standards – is the right answer, despite the recent crisis.

The choice of how high a return to seek and how much risk to accept in return

depends on each country's preferences. But choosing a financial system that can only take minimal risks is unlikely to be optimal for any country.

Financial regulation should be prudent, but not prudent to the extent of allowing for no risk, and no return either.

About the author

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Agenda for the next few months

Michael Spence

Nobel Laureate, Stanford University

Leaders should focus first on limiting the damage from this crisis in developed and developing nations. Coordinated interventions to prevent asset-price overshoot and provide fiscal stimulus are important. The longer term regulatory issues should await a careful analysis of the causes of the crisis.

There are two useful agendas that can be pursued at the Summit in Washington.

- 1) Dealing in a coordinated way with the current and still ongoing financial crisis with a view to doing whatever is possible to limit the damage.

Damage would be defined as the scope, length and depth of the recession or growth slowdown, depending on what part of the world one is thinking of, and some related distributional issue.

- 2) Setting in motion a process that is designed over time to produce a more stable and less fragile global financial system.

First things first

Of these, the first is more important. The current crisis – or more accurately the dramatically altered dynamics that took hold after the inflexion point in mid September – has been addressed with speed and pragmatism.

But the crisis is not over. An extended credit lockup (with its potential for extraordinary damage) has probably been avoided. TED and related spreads seem to have moderated. Commercial paper is being rolled over, though not through the conventional channels (which are still largely closed). The payments system is functioning; public funds are flowing into the financial system helping to recapitalise banks.

But there is a good deal more to do before we are out of the woods.

- Mortgages need to be removed from damaged balance sheets, terms reset and foreclosures limited.
- Collateralised and structured assets, not trading and with uncertain values, similarly need to be evaluated, purchased, and dismantled.

While the original conception of TARP did not act quickly enough to recapitalise the system, it remains politically and economically important.

- Homeowners need help.

Help for homeowners was part of the bargain; implemented properly it will help prevent a dramatic downward overshoot in housing prices. And it will begin the process of removing the transparency fog and therefore uncertainty about value that surrounds those portions of balance sheets with complex securitised and structured assets, one of the reasons why private and SWF capital, having been burned once, is still mostly on the sidelines.

Crisis metastasis

The financial crisis has rapidly metastasised to the global economy in part because of the growth slowdown. But more immediately and importantly because asset prices are falling and credit is drying up as capital is sucked back into the developed economies to restore damaged balance sheets, meet margin calls, and accommodate abnormally large volume redemptions. The result is that asset prices and exchange rates are being set by technical factors and the deleveraging process. They are largely unrelated to reasonable assessments of longer term intrinsic value considerations.

As a result, credit availability issues have emerged in a wide range of developing countries. Dollar denominated liabilities have become more expensive, causing stress for governments and companies – as in past developing-country crises. The difference is that this one did not, for the most part, originate with them.

After an unavoidable period of very high volatility in equity and debt markets, this will eventually end as the deleveraging storm abates and more normal valuations take hold. But the extent of the damage to household assets including pensions, hence consumption and business investment, will have a significant impact on the depth, scope and length of the global recession.

Coordinated interventions to reduce the damage

A variety of coordinated interventions from central banks, the IMF, large holders of reserves and others can help reduce the extent of an asset deflation overshoot and reduce the burden that is placed on fiscal policy and stimulus to restore economic growth. Specifically, we need to use the circuit breakers that we have to try to limit to spread of the asset deflation and its collateral damage.

Well targeted fiscal stimulus programs will be needed; they should be combined with credible plans to restore fiscal balance and healthy public-sector balance sheets over a period of time. The latter will be painful but necessary.

Longer term agenda: System stability

On the longer term agenda of reform of the global financial system, a thorough analysis of the causes of the crisis is needed as a foundation; this should be based on extensive data analysis and involve multiple inputs.

There is no shortage of potential contributing factors:

- Incomplete and fragmented regulation, specifically unregulated mortgage origination feeding the highly profitable securitisation business;
- Global imbalances, and
- Factors that led to a low inflation/low interest rate environment,
- A variety of issues associated with incentives combined with incomplete and asymmetric information,
- Transparency problems associated with the complexity of the assets and the fact that some derivatives are not traded, preventing the netting out of counterparty risk.

These deserve and will receive serious attention as an analytical foundation for the design of more effective domestic and global regulation and oversight institutions.

Shifting risk: financial innovation that hide rather than spread risk

But there is an important issue for which the current analysis is very incomplete. It seems clear (at least to me) that the financial system dynamics produced a steady rise in systemic risk (roughly the extent to which individual risks are positively correlated). This means that the distribution of risk is not stationary but instead shifts. This poses a large challenge for accurately modelling risk.

Further it appears that this rise in systemic risk went either unnoticed or not acted on or some combination of the two. The evidence is that every major financial institution held problematic assets and was highly levered and exposed to extreme financial distress. As a result they suffered simultaneous and major damage with its attendant effects on financial sector performance and on the economy. Financial innovation was believed to redistribute and reduce risk. It probably did to some extent, but in this case, innovation mainly hid the risk.

The issue of whether we know how to measure systemic risk and to detect the dynamics of its evolution is centrally important with respect to (a) whether investors and institutions can be counted on to take protective action and whether the system is or can be made to be somewhat more self-regulating, and from a policy point of view (b) whether global early warning systems (as proposed by the UK Prime Minister) and policy intervention based on a reasonably objective assessment of rising risk of instability, are in fact feasible.

About the author

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Making international finance safe for the world economy – not the other way around: What should the G20 communiqué say?

Dani Rodrik

Harvard University and CEPR

G20 leaders should unite against unilateral actions that could tip the world into a vicious cycle that deepens the global recession. This should include: (i) coordinated fiscal expansions that include consumption-expanding measures by nations with large trade surpluses; (ii) commitment to abstain from protectionist measures; and (iii) commitment to expand funding of the IMF's Short-Term Lending Facility as needed. Finally, leaders should establish a high-level working group to design new 'traffic rules' for international finance.

The G20 meeting takes place none too soon. But there is a danger that the leaders will spend too much time on grandiose ideas and not enough on containing the immediate crisis. There will be plenty of time in months to come to discuss a new Bretton Woods or a new regime of global regulation for finance. The immediate challenge is to unite against unilateral actions that could create a vicious cycle and drag the world economy into an even deeper recession.

So here is what I hope the final communiqué will say:

'We, the leaders of the G20 nations, have come together to develop a common action agenda to prevent the further spread of the financial crisis and to ensure that the consequences for output and employment are minimised. We are pleased that G7 member governments have agreed to engage in an appropriate degree of fiscal expansion to stimulate their economies. While the degree of reflation of different economies can be best evaluated by policymakers in individual countries, we believe joint action on this front will be more effective than isolated changes in policy.

We also call on countries with large current account surpluses to adopt policies that boost domestic demand. China has a particularly important role to play here, and we are happy to report that the Chinese government has decided to embark on a significant program to increase domestic consumption – both private and public – by boosting spending on infrastructure, health, education, and social transfers.

We are particularly concerned that the financial crisis, which has already hit emerging markets, will have even more serious consequences in the weeks to come for the stability of their banking and financial systems. We welcome the creation of the new Short-Term Liquidity Facility (SLF) at the International Monetary Fund, and the Federal Reserve's new swap facilities for four emerging market economies. These countries are the casualty of financial excesses that are not of their own doing. So we emphasise that access to the SLF will be available to all developing countries that are adversely affected by the financial turbulence emanating from the subprime fallout.

Further, G7 member governments emphasise that they stand ready to expand these facilities as needed, in case they are not sufficient to restore stability to markets. We also welcome the decision by the Chinese government, described in greater detail

in the accompanying communiqué, to make available part of its foreign currency reserve assets towards an expanded swap facility in support of global financial stability.

The weeks and months ahead will be trying times for economic policymakers everywhere, as they try to contain the fallout for output and employment. Raising trade barriers against imports will be a temptation, especially when currencies fluctuate so much. But the experience with the Great Depression teaches us that this is the surest way to magnify the costs of the crisis, and to spread it to other countries. Hence the most serious challenge for the global trading regime at the present is to ensure that the financial and economic crisis does not lead to a vicious cycle of protectionism, greatly exacerbating the economic downturn.

So we jointly commit ourselves in public to not raising protectionist barriers in response to perceived threats to employment from imports. We further ask the secretariat of the World Trade Organisation to monitor and report unilateral changes in trade policy, with the purpose of "naming and shaming" G20 members that depart from this commitment.

The unfolding financial crisis has made it amply clear that we need a new regulatory approach to finance – both domestically and internationally. The rules that govern financial globalisation need to be rethought to ensure that finance serves its primary goals – allocate saving to high-return projects and enhance risk-sharing – without leading to instability and crises. Our discussions have revealed that there exist great differences amongst us with respect to our respective needs and therefore with respect to how to achieve these ends. A key challenge will be therefore to strike an appropriate balance between common international regulations, on the one hand, and space for domestic approaches that may diverge from harmonised regulations, on the other. Recent experience has taught us that there may need to be a greater role for the active management of international financial flows by governments.

Designing the new “traffic rules” for international finance will take considerable time and thought. We have asked our ministers of finance to establish a high-level working group that will convene as soon as practically feasible to seek wider input, and craft a framework for discussion among heads of governments. Despite our differences on the details, we share a common goal: to make international finance safe for the world economy – and not the other way around.’

About the author

Dani Rodrik is Rafiq Hariri Professor of International Political Economy at Harvard's John F. Kennedy School of Government. He has published widely in the areas of economic development, international economics, and political economy and authored several books, including *Has Globalization Gone Too Far?* (1997), and, most recently, *One Economics, Many Recipes: Globalization, Institutions, and Economic Growth* (2007). In 2007 he was awarded the inaugural Albert O. Hirschman Prize of the Social Sciences Research Council. He is a CEPR Research Fellow.

Some suggestions for the G20 on November 15th

Willem H. Buiter

London School of Economics and CEPR

G20 leaders should better coordinate their crisis 'firefighting' efforts including recapitalisations, lending guarantees, fiscal expansions, and toxic-asset valuations. They should also set in motion institutional reforms: (i) establishing a new G7/8 (US, EU, Japan, China, India, Brazil, Saudi Arabia and possibly Russia or South Africa) with the IMF as its secretariat; (ii) boosting IMF lending capacity, and; (iii) creating a uniform global regulatory framework for rating agencies and for large, highly-leveraged institutions with significant cross-border activities.

The leaders of the G20 nations should consider two quite separate classes of decisions: putting out the fires, and adjusting global institutions.

Fire-fighting measures

Actions to be considered include:

- 1) Treasury guarantees for cross-border interbank lending, or, equivalently, central banks acting as universal counterparty of last resort in unsecured interbank transactions, including cross-border unsecured interbank lending and borrowing.
- 2) Mandatory recapitalisation of banks to a uniform international standard well in excess of the Basel II ratios.

Governments should tell banks in their jurisdictions to raise their tier one capital ratios to, say, 11% by a certain date. If the shortfall cannot be made up by the deadline from private sources, the state will inject the balance, either in the form of ordinary equity or through convertible preference shares.

- 3) A coordinated global fiscal expansion, modulated by 'ability to borrow'.

Countries with stronger government budget, current account and external asset positions should engineer a stronger fiscal stimulus; China and Germany should do more while the US and UK do less.

- 4) Fiscal bail-outs of advanced industrial countries whose systemically important banks have a solvency gap that exceeds the government's fiscal capacity.

The problem of systemically important banks or other financial institutions whose need for external resources beyond what can be financed privately exceeds the fiscal capacity of its government, is not only confined to small countries with large banking sectors and their own currencies. Switzerland, Denmark, Sweden, Australia and New Zealand are vulnerable, but so are Belgium, Ireland, the Netherlands and Luxembourg, even though they are members of the euro area.

The UK does have a large, internationally exposed banking sector. The risk of a

banking crisis whose resolution would require a foreign currency lender of last resort is real. Because sterling is not a serious global reserve currency, a combined banking crisis and sterling crisis is a threat.

Other European countries with banking sectors that are not terribly large, could nevertheless find themselves at risk because their governments are already in bad fiscal shape. Greece and Italy come to mind. I hope that behind-the-curtain contingency planning is going on in finance ministries with deep pockets.

5) Avoiding a moral hazard race to the bottom

Unless there are binding international agreements on the kind of guarantees extended by governments to financial institutions and creditors in their jurisdictions, we will see a replay of the moral hazard explosion that followed the Irish decision to guarantee all liabilities of the six largest majority Irish-owned banks.

The result could be every creditor fully guaranteed and taxpayers taken to the cleaners. Not only would this be outrageously unfair, it would create terrible incentives for future reckless lending. The IMF should monitor and police any norms adopted.

6) Agree common access rules and common methods for valuing illiquid assets in different national TARP-like structures

TARP-like toxic asset dumps are essential for understanding the true balance sheets of banks and other highly leveraged institutions, and are key to cleaning up of banks' balance sheets (through mark-to-market accounting rules) and to a resumption of securitisation markets.

There should be common rules on who gets access to the toxic asset dumps managed by different nations. There also should be common methods for valuing illiquid assets, lest the same asset gets valued in different ways at different national TARPs, putting excessive strain on the public finances of the country offering the highest valuation.

Institutional reform

1) Increase the financial resources of the IMF

Its current lending capacity (about \$250 billion) is peanuts. If any of the larger emerging markets (Turkey, Brazil, Indonesia, Poland, or Korea) gets into trouble, \$250 billion will be gone before you can say 'Special Drawing Rights'.

An additional \$750 billion would be the minimum required for the IMF to play a helpful part putting out emerging market fires; \$1.75 trillion would be required for the IMF to be able to act in a systemic emerging markets crisis without first having to arrange bilateral financial support for the intervention by a number of deep-pocket national governments, each one of which would then have effective veto power over the programme.

2) Reform the G7/8

There is an urgent need to constitute a new G7/8 comprising the US, the EU (represented at the head of government/head of state level by the EU presidency – adopting the Lisbon Treaty would be helpful here), Japan, China, India, Brazil, Saudi Arabia and possibly Russia or South Africa.

3) Change IMF quotas and voting rights in line with shares of world GDP at PPP

exchange rates, subject to the constraint that no country has veto power (18% of the total votes or more).

4) Turn the IMF into the permanent secretariat for the new G7/8.

5) Agree to adhere rigorously to mark-to-market accounting and reporting principles and agree on common rules for relaxing regulatory requirements attached to marked-to-market valuations

It has taken decades to agree on mark-to-market (or 'fair value') accounting and reporting. It would be the height of insanity to throw that achievement out of the window because regulators cannot apply common sense in their application of capital ratios, liquidity ratios and other regulatory requirements that are influenced by marked-to-market asset valuations. The regulatory consequences of valuation distortions can be adjusted, in a uniform, internationally coordinated manner.

6) Take steps towards a single global regulator for large highly leveraged institutions that have significant border-crossing activities.

The domain of the single regulator/supervisor has to be congruous with the domain of the market and the domain (geographically and as regards activities) of the systemically important highly leveraged institutions. An important interim step is to create a single US regulator and a single EU-wide regulator for large highly leveraged institutions that have significant border-crossing activities.

7) Permit capital controls and barriers to entry by foreign entities into national or regional (EU) financial markets and industries, in cases where there is not a single regulator/supervisor for the markets/instruments or for the entities and their foreign parents, subsidiaries and branches in all countries where they are active.

8) Create a uniform global regulatory framework for rating agencies.

Eliminate their quasi-regulatory function. Make it impossible to combine rating activities with other profit-seeking activities in the same legal entity. If payment of rating agencies by the issuers is to continue, the selection of the rating agency should be done by the regulator, not by the individual issuer.

9) Don't waste time on multilateral surveillance.

The IMF will never have any influence on large member states with strong government budgetary positions and strong external positions.

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Reforming global economic and financial governance

Raghuram Rajan

University of Chicago, ex-Chief Economist of the IMF

G20 leaders should focus on global governance and should boost the IMF's financial fire-power. Global financial coordination requires a broader group than the G7 or G20. The EU should get only one chair in the 'G20+' to allow broader representation. The Secretariat for this group should be a reformed IMF. The IMF's lending capacity should be immediately increased by allowing the Fund to leverage its member quotas at a ratio of between 5 and 10 to 1.

The central problem in fostering global economic dialogue is that it is currently a 'dialogue of the deaf'.

- Industrial countries stopped requiring financing long ago; they now believe they are responsible global citizens, and guard their policy independence carefully. It seems they view the primary role of multilateral institutions as correcting the policy mistakes and the naked mercantilism of emerging markets, and – of course – providing aid to the very poor.
- Emerging markets feel they have come of age; they believe multilateral institutions follow an agenda set by the industrial countries, and don't see why their own policies should be under scrutiny when industrial countries show scant regard for the multilateral institutions (other than to enforce their bidding).
- Developing countries, beset with their own problems, have little time or interest in a global agenda.

Unfortunately, global problems are mounting, and the problems are not just financial. The availability and pricing of resources is, as we have realised in recent years, of critical importance. Ideally, such resources would be produced and allocated by a free market to which everyone has access. Unfortunately government action distorts the market. Decisions by small groups of countries on issues ranging from promoting bio-fuels to restricting investment in, or production of, oil, have enormous impact. As other countries try and adopt strategies that shield themselves from resource shocks, everyone's access to resources is impaired. Dialogue can help us reach a better global solution.

Similarly, even though the world may have learnt the dangers of beggar-thy-neighbour strategies in trade, echoes are still seen in cross-border investment. More barriers are being contemplated in industrial countries to investment from emerging markets. Old barriers, under the guise of promoting domestic stability and security, also exist -- all this while emerging markets have historically been exhorted to reduce their barriers to investment, and in some cases are doing so. It is important that we start a global dialogue on the admissible rules of the game in cross-border investment.

Finally, global financial integration, while helpful, has increased the size of the

shocks that countries are subject to, especially when private capital seizes up. The size of resources available to multilateral institutions like the IMF has not kept pace with the size of potential shocks and the needs of large emerging markets.

Key issues for the November 15th meeting

In the interests of space, I will focus in what follows on

- Governance, and
- The availability of emergency finance.

Progress on these two fronts, initiated by the international conference in November 2008, would be enormously beneficial.

Governance: A G20+ with only one seat for the EU nations

There is clearly a need for better international economic dialogue, facilitated by an impartial secretariat that lays the issues on the table. There is merit in having only a few key participants so that there is dialogue and not a formulaic restatement of positions.

- The G-7 is probably too small and unrepresentative;
- The G-20 is probably at the limit of what might work, but unfortunately, is still unrepresentative.

More thought needs to be given to constituting a group consisting of all major countries, with some representation of smaller countries and regions through rotating seats, and some special invitees based on the relevance of the topic.

One change that would help make such a group feasible is to have a single seat for the EU. The non-EU countries in the G-20 plus the EU would make 16, to which could be added 4 countries on a rotating basis, or based on topic. Let us call this the G-20+ in what follows.

A reformed IMF as the G20+ secretariat

The obvious secretariat is the IMF. Unfortunately, the Fund suffers the burden of history, and its objectives and governance are still not sufficiently transparent so as to make it widely trusted by emerging markets. This hampers its functioning as an honest broker. Important reforms are needed at the Fund, including:

- Broadening its mandate beyond exchange rate surveillance, which tends to put only emerging markets under scrutiny,
- Making the Fund self-financing so that it does not have to keep going back to key shareholders (which effectively gives them a veto over Fund activities),
- Eliminating any country's official veto power over major decisions,
- Making the choice of management transparent and nationality-neutral, and
- Allowing the Fund's agenda to be set by the more representative G-20+ described above.

Even while these changes are in train, there is merit in beefing up the Fund's global surveillance unit, and perhaps allowing it to report directly to the G-20+, and to the IMFC (International Monetary and Financial Committee), without its opinions being heavily edited and filtered by the Fund's Board of Governors. The Fund's multilateral

surveillance should focus more sharply on emerging risks – this involves strengthening macro-financial analysis and early warning systems. Also the G-20+ should focus on the identification of remedies when serious risks are diagnosed – here early coordination with other policymaking and advisory agencies would help.

Changed role for the IMF and World Bank Boards

There is some merit in discussing whether there is any need for the Fund and the World Bank to continue to have permanent boards, an anachronism that dates from the time when distances were large and communication difficult. Those boards could be reconstituted much like the boards of corporations, with quarterly meetings, and a focus on broad governance rather than on management details. The mid-level functionaries who now are on the board could then be replaced by high-level deputies, who fly in for meetings, and would have a greater capacity to undertake dialogue.

Indeed, in times of crisis, the boards, consisting of high-level finance ministry deputies, could easily turn into crisis management teams that coordinate any collective response, much as the G-7 deputies do today.

Financing firepower

The IMF has an aggregate lending capacity of about \$250 billion, probably sufficient if a number of small countries are in trouble, but insufficient if a couple of large countries face problems. If the multilateral system does not have adequate firepower, countries will have to rely on bilateral arrangements, with all the difficulties that it entails. It is not that resources are not available amongst emerging markets and industrial countries. The need is to find a way to pool them.

Such resources are needed to build confidence in emerging markets (the swap arrangements announced by the Fed with four emerging markets were a powerful and welcome signal to investors). Moreover, if we do nothing to address this issue, we will set up serious problems for the future. We will emerge from the crisis with many countries attempting to build reserves through export-led strategies and managed exchange rates, aggravating the demand imbalances that are at the heart of the current crisis.

Incremental is insufficient

The resources at the Fund's command, disbursable through light-conditionality facilities like the new Short Term Liquidity Facility should be multiplied by an order of magnitude. One possibility is to expand the Fund's arrangements to borrow from countries with large reserves, or from financial markets. In order to limit the liability of member countries, while at the same time bringing transparency to the process, the current quotas of member countries could be treated as the equity capital backing the borrowing. This is simply a formalisation of the loss-sharing arrangement that currently exists. At normal financial institution leverage ratios of 10 to 1, the Fund could borrow up to 10 times member quotas of \$340 billion. Even if it maintains leverage at more conservative levels of 5 or 6 to 1, this will be a sizeable expansion of potential fund resources to about \$2 trillion, enough to deal with most eventualities. Ideally, this capacity would never be tapped, but it is important to create it.

About the author

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Not a New Bretton Woods but a New Bretton Woods process

Barry Eichengreen

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The November 15th meeting should explore the idea of a new "World Financial Organization" that, like the WTO, would blend national sovereignty with globally agreed rules on obligations for supervision and regulation. It should agree to immediately boost the IMF's lending capacity, with nations like China contributing in exchange for a revamping of the old G7/8 group into a new G7 (US, EU, Japan, China, Saudi Arabia, South Africa and Brazil) that would provide a proper global steering committee.

Now that the quashing of excessive expectations is complete, it is time to ask what can realistically be accomplished by heads of state meeting in Washington on November 15th.

Basic orientations should be obvious.

- Leaders should focus on financial stability.
- They should commit to a series of meetings.
- They should strive for a process rather than a quick, hollow agreement.
- They should acknowledge that consensus, like Rome, is not built in a day.

Central challenge: consistent supervision and regulation with comprehensive coverage

Their central challenge is how to ensure comprehensive and consistent supervision and regulation of all systemically significant financial institutions, and cross-border financial institutions in particular. The crisis is a reminder that inadequate supervision at the national level can have global repercussions. Addressing this problem is the single most important step they can take to make the world a safer financial place.

There will be calls for a global regulator, echoing proposals for a World Financial Authority by John Eatwell and Lance Taylor a decade ago. But it is unrealistic to imagine that the US and for that matter any country will turn over the conduct of national financial regulation to an international body. (The US has already signalled its position on this question.) Regulation of financial markets is a valued national prerogative. Not even EU member states have been willing to agree to a single regulator. In any case there is the particularity of national financial structures, which places effective oversight beyond the grasp of any global body.

Create a "World Financial Organisation" in the image of the WTO

The European proposal for squaring this circle by creating a College of Regulators is weak soup. We need more than information sharing and discussions. Better would be

to strive to create a World Financial Organization analogous to the World Trade Organization. Countries seeking access to foreign markets for financial institutions they charter would have to become members of the WFO. They would have to meet the obligations for supervision and regulation set out in its charter and supplementary agreements. But how they do so would be up to them. This would permit regulation to be tailored to the structure of individual financial markets.

An independent body of experts, not unlike the WTO's Dispute Settlement panels, would then decide whether countries have met their obligations. A finding of lax implementation would have consequences. Specifically, other countries could prohibit banks chartered in countries found to be in violation from operating in their markets. This would protect them from the destructive spillovers of poor regulation.

It would also foster a political economy of compliance. Governments seeking to secure market access for their banks would have an incentive to upgrade supervisory practice. Resident financial institutions desirous of operating abroad would be among those lobbying for the requisite reforms.

Would the US accept a WFO?

Sceptics will question whether countries like the United States would ever accept having an independent panel of experts declaring the US regulatory regime to be inadequate and authorizing sanctions. But this is just what the WTO's independent dispute settlement panel does in the case of the trade regime. Why should finance be different?

Creation of a WFO is not a be-all and end-all. Trading in derivative securities should be moved onto an organized exchange to limit counterparty risk. Basel II should be urgently reformed to raise accepted measures of capital adequacy, reduce reliance on commercial credit ratings and banks' models of value at risk, and add a simple leverage ratio. These steps can and should be taken relatively quickly. But commencing negotiations on a World Financial Authority would be the most important single step.

Why a new international organisation?

It would be preferable to create the WFO as a new entity rather than building it on the platform of an existing institution like the IMF or the Financial Stability Forum. The Financial Stability Forum is dominated by the G7 and the various international organizations with only Hong Kong and Singapore as token "emerging-market members." The IMF has the advantage of universal membership, but its past capital-market surveillance has not exactly covered it in glory. The Fund continues to be regarded with suspicion in Asia and Latin America. Countries there would be reluctant to sign up to a World Financial Authority that was a wholly owned and operated subsidiary of the IMF. This reality is also evident in the reluctance of governments like China's to deploy their reserves in support of other countries by channelling them through the Fund.

The other key challenge: boost the IMF's lending capacity

This brings us to the other key challenge that must be met to make the world a safer financial place: mobilizing the resources, both financial and political, of emerging markets. The IMF desperately needs additional funding to aid crisis economies, and governments like China's are the logical contributors. The question is what to give

them in return.

We cannot afford another inconclusive multi-year negotiation of new IMF quotas. More effective would be for the US, Europe and Japan to agree to abandon the G7/8, which is no longer a suitable steering committee for the world economy, in favour of a new G7 composed of the US, the EU, Japan, China, Saudi Arabia, South Africa and Brazil. This would not require negotiations among hundreds of countries stretching over a period of years – time which is not available given the urgency of the task. It would give China and the others a seat at a table that really matters. It would give them ownership and the sense that they have a stake in the stability of the global economy. This would not exactly be a club of democracies, but then it was the ‘talk-to-who-matters’ man and not the ‘club-of-democracies’ man who won the US election.

In addition, Europe could agree to a single executive director on the IMF board, freeing up directorships for emerging markets. And who better than a far-sighted European leader like Dominique Strauss-Kahn to announce that leadership of the Fund should be thrown open to the most qualified candidate regardless of nationality? But while all this would be helpful, creating a new G7 would be the most important single step.

Starting on November 15th, everyone will roll out their pet ideas, from a substantial revaluation of the renminbi to a global system of target zones to a single world currency. (You know who you are!) But it is important to avoid non-starters and superfluous initiatives. Creating a new G7 now and committing to establish a World Financial Organization soon are the ways forward.

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The new international financial architecture requires better governance

Stijn Claessens

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New rules and institutions are needed to reduce systemic risks, improve financial intermediation, and properly adjust the perimeter of regulation and supervision. This could mean an 'International Bank Charter' for the world's largest, most international banks with accompanying regulation and supervision, liquidity support, and remedial actions as well as post-insolvency recapitalisation funds in case things go wrong. The starting point, however, has to be a change in the governance of the international financial system.

As Heads of State gather in Washington, DC on November 15th to discuss the new international financial architecture, four questions should be on the agenda:

- How can we improve financial regulation, as the systemic nature of the crisis shows that current approaches lag behind events?
- How can we improve regulatory practices and information, as current approaches differ too much across countries and information gaps have been widening?
- How can we design better liquidity mechanisms at a global scale to prevent spillovers from becoming solvency issues?
- How can we ensure greater coordination and burden sharing, especially when financial institutions fail?

No doubt, leaders will conclude that this agenda will have to be addressed in phases and more background work and meetings will be necessary. And the ongoing economic and financial crises may force them into some emergency policy making.

But, perhaps they can at least agree on the most important starting point – reforming the governance of the international financial system. Better governance is needed for various reasons – it comes back under each question – and any new architecture needs broad legitimacy. Maybe the governance reform can start at this G20 Summit, in part since more than the usual number of countries will be present.

Better regulation was needed long ago; the crisis makes it obvious

Financial innovation and integration have increased the speed and extent to which shocks are being transmitted across asset classes and countries. Innovation and integration have blurred boundaries, including between systemic and non-systemic institutions.

New rules and institutions are needed to reduce systemic risks, improve financial intermediation, and properly adjust the perimeter of regulation and supervision – all this without imposing unnecessary burdens. Accomplishing this task will require much new thinking. Designing counter-cyclical, macro-prudential rules and reducing

systemic risk are particularly difficult. Designing such rules involves important governance issues. What processes will be followed for the development of the rules, standards and best practices? Will it again be done in small groupings of policymakers from advanced countries, with much private sector influence, or will it be more balanced this time, representing broader interests?

Regulatory convergence is not enough, common practices are needed

Broad participation in rulemaking will help as it increases legitimacy and eases the enforcement of rules. But it will not suffice; assessments of practices are still needed. The market can do some of this, but the crisis has again confirmed the need for public sector involvement. Here governance issues must be addressed: What form should this monitoring of regulators and regulation take? Who should do it, how should it be governed, and how should flags be raised when rules are not followed or practices fall behind?

More information and enhanced liquidity provisions

The crisis has highlighted the size of information gaps we face, both nationally and internationally. More and better information is needed if markets and authorities are to better assess the build-up of systemic risk. Addressing this requires a review of rules on transparency, disclosure and reporting. Information requirements will also need to cover a much larger set of institutions ranging from insurance companies to hedge funds, and off-balance sheet entities. More information will not emerge by itself. Moreover, the temptation will be to hoard new information, so proper governance structures are needed to ensure sufficient information is available to those who need it.

The current crisis has shown that in times of turmoil, even among developed countries, liquidity provision for financial institutions is not efficient, leading to confusion and higher costs. For emerging markets and developing countries, a temporary shortage of liquidity can be even worse. Again today, as has happened before, foreign investors are rapidly reducing their exposures and many countries, even those with otherwise good fundamentals, are greatly suffering from "sudden stops". These liquidity strains easily become solvency crises if not dealt with swiftly and effectively.

The lack of a sufficiently large, global liquidity provider

The IMF's resources are too small in today's world. Advanced countries' central banks swap lines are to date only available for some emerging countries. While regional pools of reserves, such as in Asia, provide a backstop, they can be too small. These approaches could be broadened and expanded: the Fund can get more money; greater coordination on swaps can be pursued; and larger pools of central bank money can be created. Fixing this again entails governance since what is crucial in the end is who gets to decide on liquidity provision. The fact that bilateral and regional approaches dominate so far suggests that truly multilateral solutions, with attendant risk-sharing and pooling benefits, are still viewed with some scepticism. Again better governance arrangements can make for improved outcomes.

In the end, many international financial architecture questions relate to burden-sharing. Consider the issue of international financial institutions. The crisis has clearly underscored the tension with regard to both risk prevention and crisis management between nationally bounded supervisors and large financial institutions that

transcend national borders, have extensive operations across a large swathe of countries, and can be major transmitters of shocks. The tension is most evident in the resolution of global banks headquartered in relatively small countries that have balance sheets exceeding their home-country's GDP. Few single countries can deal with such institutions on their own, yet they affect many markets. Clearly, in this crisis, and even more so going forward as they will keep getting larger, a better method has to be found to handle these institutions.

A new regime for large, international banks

One internally consistent approach, perhaps the only one, is to establish a separate regime for large, internationally active financial institutions. This could mean an "International Bank Charter" with accompanying regulation and supervision, liquidity support, remedial actions, as well as post-insolvency recapitalisation fund in case things go wrong.

The idea is that a separate international college of supervisors, with professionals recruited internationally, would regulate, license and supervise these institutions. The arsenal of remedial actions available to supervisors would include: limits on operations, risk-taking, and capital as well as cease-and-desist orders. These actions should be as rule-bound as possible. The recapitalisation fund could be fed by a fee paid by these banks themselves. Like a deposit insurance agency, the fund would need callable capital from its shareholders, the governments sponsoring the concept, with contributions based on, say, on GDP (since the ultimate gains relate to the real economy). In exchange for subjecting themselves to this regime, these banks could operate around the world without any further permission (except for country-specific requirements, such as macro-prudential requirements to mitigate booms or systemic risks).

This approach would differ from the ones tried and tested, but which have often failed in past (e.g. the messy constellation of home and host supervision in various Basel agreements). It would get around the problem that coordination is hard to agree on ex-ante, especially of actions aimed at containing and resolving a crisis. In the current crisis, as in the past, actions regarding large institutions were largely determined ex-post, and aimed only at (near) insolvent institutions, rather than being pre-emptive. While eventually there were more concerted and coordinated interventions, these happened only under great financial duress, were sometimes undone, and created unexpected repercussions in other markets.

A common and well resourced regulator is a much better solution; coordination is assured, and if intervention is necessary the regulator's powers are backed by sufficient resources to make it credible.

Author's note: The views expressed in this paper are those of the author and do not necessarily represent those of the IMF or IMF policy.

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Europe's two priorities for the G20

Daniel Gros

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G20 members should boost IMF independence so it can act as a global 'whistleblower' to help call the next crisis. They should also start to bring the reach of banking supervisors more in line with the reach of banks. The failure of regulators to exchange confidential information led national agencies to miss the systemic risk that arose when banks across the globe followed similar strategies.

Generals, it is said, design their armies to fight the last war. Regulators, by analogy, design rules to prevent the last crisis.

This explains today's focus on securitisation and rating agencies; attention which is misdirected. The securitisation market has ground to a halt and the market views all ratings with a healthy dose of scepticism; these two areas should not figure high on the agenda for the reform of the global monetary system.

The current crisis had a number of causes, some of which cannot be addressed – much less prevented – by even the best designed global monetary system. For example, the under-pricing of risk in almost all financial markets until 2007 was a global phenomenon; regulators could not have prevented it. Nonetheless, something could have been done.

- Monetary policy should have reacted earlier to the boom in house prices, and
- Regulators should have forced banks to accumulate larger reserves for the tougher times that had to come sooner or later.

The root causes of these two macroscopic failures need to be understood properly before we try to create a new Bretton Woods.

Root cause of the macro failures

The failure of central banks to react to the rising bubbles was not due to a poorly designed global system. It represented the dominant ideology over the last decade. An ideology which held that bubbles could be correctly diagnosed only after they burst. The job of central banks was to minimise the damage to the real economy by lowering interest rates.

This approach is now totally discredited. While we are unlikely to see another bubble emerging anytime soon, 800 years of financial crises teach us that there will be another. At that point, the global monetary system will need a 'whistleblower' – an organisation which has the expertise to diagnose a bubble and the clout to make its voice heard.

The BIS did repeatedly warn about the build up of risk in financial markets, but its warnings were not heeded. The IMF is much better placed to be the world's whistleblower, i.e. to look at the macroeconomic dangers resulting from an excessive accu-

mulation of leverage. But this would require change. The IMF would have to be sufficiently independent from its political masters, i.e. its larger members, especially the US.

The G20's first priority: Boost IMF independence

A first item on the agenda for reform of the G20 should thus be not only an extended remit for the IMF to look at financial market stability, but also a much higher degree of independence so that it can actually warn of dangers even if this is politically inconvenient for its major shareholders. The creation of the unified Euro Area IMF representation might be step in this direction as it would break the US veto on criticism of US policy.

The G20's second priority: matching the reach of banks' and supervisors'

The second macroscopic failure mentioned above (lax supervision of banks) stems mainly from the fact that supervision remained national while the larger banks operated increasingly transnationally.

The problem is particularly severe in Europe where a dozen large complex international banking groups have emerged. These are too large to fail, but some of them are also too large to be saved by their home country alone.

National supervisors allowed this to happen because they perceived as their mission mainly to help their own national champions. This perceived competition among national supervisors meant that they did not focus on their main mission – controlling risk taking. It also restricted exchange of crucial confidential information among national supervisors. This failure to exchange information meant that national regulators could not see the systemic risk that arises when all banks follow the same strategy.

National supervisors were confident that the situation was under control because they undertook many stress tests. But none of these stress tests could reveal the consequences of problems arising simultaneously in more than one market because no national regulator had access to information from other countries, and there was no European institution to look at the stability of the European banking system as whole.

Internationally-integrated banking with national supervision spells trouble

The conclusion is clear – an internationally integrated banking market is not compatible with exclusively national banking supervision. To date, European policymakers have refused to recognise this. The latest French Presidency proposal mentions only the creation of so-called 'colleges' of supervisors. This will not be enough.

At a minimum, EU national supervisors will have to follow the same (European) rulebook to avoid a race to the bottom as nations compete on laxity. They must also regularly exchange all information concerning systemically-important institutions so that systemic risk can be recognised early.

The same degree of cooperation among supervisors would likewise be needed for the small number of banks that are systemically-important at the global level. It is unlikely that this can be organised at the global level, however, if it does not happen first within Europe.

Europe could have been the major driving force for a reformed global monetary system. But as long as the EU is not able reform its own internal organisation its con-

tribution will remain minor. Given that the US has no strong interest in changing the status quo it is thus likely that little will change.

Nevertheless, G20 leaders should flag the issue for further discussion. If the damage spreads much further, the logic and indeed the necessity of European and global coordination of bank supervision may make itself felt forcefully enough to overpower national jealousies and doubts. In the meantime, European leaders should get their own house in order.

About the author

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Returning to narrow banking

Paul De Grauwe

University of Leuven and CEPR

Bubbles and crashes have been part of financial markets for centuries. Allowing banks - which inevitably borrow short and lend long - to get deeply involved in financial markets is a recipe for disaster. The solution is to restrict banks to traditional, narrow banking with traditional oversight and guarantees, while requiring firms operating in financial markets to more closely match the average maturities of their assets and liabilities.

There can be no doubt that a reform of the international financial system is necessary to avoid future crises. However, the G-20 meeting should also avoid an agenda that takes on too many problems. The leaders need to focus on the essential problem – the international banking crisis and the factors that led to this crisis.

Banks inherent instability

It is useful to start from the basics. Banks are in the business of borrowing short and lending long. In doing so they provide an essential service to the rest of us, i.e. they create credit that allows the real economy to grow and expand. This credit-creation service, however, is based on an inherently fragile system. If the banks' depositors or lenders are gripped by collective distrust and all decide they want their money back, bank will go broke; the money is not there since the deposits were invested in illiquid assets. This is how a liquidity crisis erupts, setting in motion an devilish cycle of insolvency and new liquidity crises.

Repeal of stability regulation

We learned from the Great Depression that in order to avoid such crises we have to limit risk taking by bankers.

We unlearned this lesson during the 1980s and 1990s when the banking sector was progressively deregulated, thus giving banks opportunities to seek high risk investments. The culmination of this deregulatory movement was the repeal of the Glass-Steagall Act in 1999 under the Clinton Administration. This ended the separation of the commercial and investment banking activities in the US – a separation that had been in place since the 1930s banking collapse. Repeal of the Glass-Steagall Act opened the gates for US banks to take on the full panoply of risky assets (securities, derivatives and structured products) either directly on their balance sheets or indirectly through off-balance sheet conduits.

Similar processes of deregulation occurred elsewhere, in particular in Europe, blurring the distinction between investment and commercial banks, and in the process creating "universal banks". It now appears that this deregulatory process has sown the seeds of instability in the banking system.

The critical lack of a firebreak

Financial markets have, for centuries, been gripped by speculative fevers that have led to bubbles and crashes; bubbles and crashes are an endemic feature of financial markets. But financial market problems do not automatically affect banks. In the most recent crisis, bubbles and crashes would not have been a major problem had banks not been involved so deeply in financial markets. Banking sector deregulation, which started in the 1980s, is what exposed the banks so catastrophically to the speculative dynamics inherent in financial markets. Banks' balance sheets became the mirror images of bubbles and crashes occurring in the financial markets. An explosive cocktail of credit and liquidity risks was created that was waiting to explode.

The failed Basel approach

The Basel approach to stabilise the banking system is based on an attempt to model the risks universal banks take and to compute the required capital ratios that will minimise this risk. Such an approach is unworkable. The risks that matter for universal banks are "tail risks", i.e. events which are extremely rare but which cause extremely large losses – like AIG's near bankruptcy, or Lehman being allowed to go broke. Such risks cannot be accurately modelled (a key element of the Basel approach) precisely because they are so rare.

The only workable approach to ensuring bank stability

This leaves only one workable approach. This is a return to narrow banking in which the range of activities in which banks are allowed to engage is narrowly circumscribed. In this approach banks are excluded from investing in equities, derivatives and complex structured products. Investment in such products can only be performed by financial institutions, e.g. investment banks, which are then forbidden from funding these investments by deposits (either obtained from the public or other commercial banks).

In a nutshell a return to narrow banking could be implemented as follows:

- Financial institutions would be forced to choose between the status of a commercial bank and that of investment bank.
- Only the commercial banks would be allowed to attract deposits from the public and from other commercial banks and to transform these into a loan portfolio with a longer maturity (duration).
- Commercial banks would benefit from the lender of last resort facility and deposit insurance, and would be subject to the normal bank supervision and regulation.
- The other financial institutions that do not opt for a commercial bank status would have to ensure that the duration of their liabilities is on average at least as long as the duration of their assets.

This last point would imply, for example, that they would not be allowed to finance their illiquid assets by short-term credit lines from commercial banks.

International coordination to avoid a classic, regulatory race-to-the-bottom

A return to narrow banking can only occur if it is embedded in an international agree-

ment. This is where the G-20 comes into the picture.

When only one or a few countries return to narrow banking, the banks of these countries will face a competitive disadvantage. They will lose market shares to banks less tightly regulated – a result that would produce forceful lobby against the restrictions. In the end, the governments of these countries will yield and the whole process of deregulation will start again.

A comprehensive international agreement will be necessary to remodel banking systems and to separate commercial banks from investment banking activities. This is what a Bretton Woods II conference should focus on.

Clearly there are other desirable reforms, such as improving the incentive structures of bank managers and rating agencies, and a better representation of emerging countries in the IMF. The focus of Bretton Woods II, however, should be to reform the banking system so that it does not get involved in bubbles and crashes that are endemic to financial markets.

About the author

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G20 Summit: What they should achieve

Takatoshi Ito

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Four issues demand G20 attention: (i) improved surveillance mechanisms to avoid future crises, (ii) reinforced liquidity support for small nations hit by shocks originating from other nations, (iii) better coordination of national financial supervisory and regulatory frameworks, and (iv) international agreement on bankruptcy procedures for large banks with extensive transnational involvement. Reform of the IMF is critical to all of these.

The current global financial crisis has made it obvious that we need to reform the international financial system including the World Bank, but especially the IMF.

First, **surveillance** of advanced economies as well as emerging market economies remains weak; this is why appropriate warnings were not issued or not taken seriously when issued. World leaders should have been warned more forcefully about the US housing bubble, Iceland's oversized banking sector and capital inflows, and macro vulnerability of several central European countries.

Second, **liquidity support** by the IMF and the World Bank for nations facing sudden capital outflows, yet good fundamentals, has to be strengthened further. An unlimited amount of support, with little conditionality, should be introduced. The IMF should become a lender of last resort.

Third, **supervisory and regulatory frameworks** of private financial institutions differ across national boundaries, although the private activities go beyond national borders. The geographic reach of supervision and regulation must be brought closer into line with the reach of private financial activities. For example, supervision of banks but also securities firms and insurance companies has to be strengthened. Basel II has to be modified to take into account lessons from the current crisis. Deposit insurance systems, non-discrimination concerning foreigners' deposits, and other principles for protecting small investors must be coordinated.

Fourth, **bankruptcy procedures for financial institutions** are different across national borders, so that it is extremely difficult to fail internationally-active institutions that engaged in high-risk investments and lost.

Without a procedure to fail such institutions, they have to be bailed out to avoid serious international consequences (such as the freezing up of global money markets upon Lehman's demise). The balance between protecting financial stability and preventing (future) moral hazard should not be biased in favour of stability simply because we do not know how to fail an internationally-active, large and complex institution. The IMF should become an international financial bankruptcy coordinator.

The G20 financial summit should address at least these four challenges. This will require important changes in the World Bank and IMF. Here are the four most important:

(1) **Independence** is key for successful surveillance.

In order for the IMF (and the World Bank) to publish impartial analysis of macroeconomic fundamentals and early warning, the IMF management and staff should be "independent" of large shareholders. Currently, the surveillance process – a mission to the country, Article-IV country reports, etc. – is under tight control of the Executive Board, i.e. dominated by the largest members. The Executive Board sometimes intimidates staff into watering-down strong warnings. For deeper analysis on this point, see the De Gregorio, Eichengreen, Ito and Wyplosz proposal.

(2) **New lending facility** to help liquidity-strapped, but solvent governments is needed to fill the gap in IMF lending facility.

When a small country experiences large capital flows for reasons that originate in other countries, the country should be helped by the IMF without stigma. This can be achieved by extending unlimited amount of short-term liquidity support from the IMF with little conditionality attached.

The amount for lending should not be tied to the multiple of the country's quota, which is the case in the recently announced Short-term Liquidity facility (SLF), nor should it entail a penalty interest rate, which is the case in Supplemental Reserve facility (SRF). Rather it should be calibrated to the size of the capital flows necessary to fill the gap. After all, these will be cases where nations are suffering from contagion and part of the purpose of this financing is to stop the contagion from spreading to other nations. This change is closely related to the Meltzer proposal for IMF reform. In the event that IMF resources run out, the new fund for liquidity support has to be supplemented with some willing donor countries with large foreign reserves.

(3) **The IMF's Financial Sector Assessment Programme should be strengthened.**

Coordination of the IMF, BIS, and FSF (Financial Stability Forum) is needed to establish the 'best practice' concerning supervisory and regulatory frameworks for financial institutions – banks, securities firms, and insurance companies. Countries may have to make many changes to their financial system. As the crisis has so painfully illustrated, their current systems aren't good enough.

(4) **International Financial Bankruptcy Court.** When an internationally active financial institution fails, the regulator in each country freezes the asset of its branch and subsidiary. The intention is to protect small investors in the country. However, since the bankruptcy laws (say, Chapter 11 in the US) differ across countries, liquidation of asset positions and returning assets to creditors has become extremely difficult. This is being painfully learned in the process of unwinding of Lehman assets. An international bankruptcy court, in which the IMF can play the role, should be established to disentangle the complex transactions in a timely manner.

Conclusion

The G20 leaders should focus on these four issues. They should agree on the way forward in establishing a strong, independent IMF.

About the author

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Delivering change. Together.

Wendy Dobson

University of Toronto

Leaders should observe several key principles: (i) do no harm; (ii) avoid finger pointing; (iii) moderate expectations of global action; (iv) be unanimous in selecting a few goals and then deliver. The priorities should be to agree a coherent regulatory framework (new rules, not a new institution), hasten IMF restructuring, stimulate the real economy and permanently replace the old G7 with the G20.

Restoring public confidence in economic globalisation and financial markets should be leaders' top priority. New organisations designed in haste are not necessary. Most of what is required already exists. Make the existing institutions more effective and legitimate in preventing crises and managing them when they occur.

Where to start

First, leaders should start by agreeing on a coherent international framework for regulating financial institutions and markets that encourages strong and appropriate oversight within countries as well as removing the cross-country gaps and inconsistencies that provide loopholes and opportunities for regulatory arbitrage.

The Financial Stability Forum, created on a BIS (Bank for International Settlements) platform after the 1997-98 Asian crises, is a good start. It already promotes cooperation among national supervisors of financial institutions involved in the insurance, securities and foreign exchange markets. It does the same for financial infrastructure institutions as credit rating agencies, accounting standards, and others. Leaders should strengthen its mandate to develop best-practice guidelines and universal standards to guide the reforms of national regulators.

Central banks have demonstrated that it is possible to have a coherent international framework that achieves the same ends in diverse national economies. Central bank governors meet regularly in unremarked meetings at the BIS; they have been cooperating quickly and seamlessly to support global liquidity as far back as the 1987 stock market crisis. Their record is not perfect, however. They did not persuade US monetary authorities to tighten lax monetary policy in recent years, nor have they convinced the Chinese government that the central bank's heavy focus on exchange rate management contributes to global as well as domestic distortions and imbalances.

Hasten IMF restructuring

Second, leaders should speed up IMF restructuring. It has the necessary expertise and membership to be the lender of last resort. But it no longer has the resources or clout.

The IMF must restore the trust of Asian governments and change its governing

structure to give clout to those who can provide resources, including governments with sovereign wealth funds. Its collective experience – having handled more than one hundred banking crises – is a source of significant expertise. It has mechanisms for emergency finance and for conducting macroeconomic surveillance to track cross-country financial and economic linkages. Its Financial Sector Assessment Programs (FSAPs) are a source of credible and comprehensive analysis and advice – although one that the US ignored (the IMF's warnings of impending problems in its surveillance reports and semi-annual surveys of the world economy went largely unheeded.)

Help the real economy

Third, G20 leaders should accord a high priority to the real economy.

External imbalances still need to be reduced by governments adopting national policies that are good domestic policy as well. A worrisome development is the growing perception that globalisation is bad for the middle class.

A strong pledge by leaders to eschew protectionism is essential. The best signal of such commitment is to complete the Doha Round by year's end. The lessons from the 1930s demonstrate the disastrous consequences of trade protectionism and lack of mutual trust and cooperation among governments. Nationalism and protectionism trumped the global public interest and the crisis deepened. This must not be allowed to happen again.

Establish a new 'G7' to match New Century realities

Fourth, leaders should permanently restructure the global leaders' group. This is not a topic that should top the agenda because it will use all the "oxygen," but it is an important one. G-20 membership is based on criteria of economic significance and location which give it legitimacy. It should replace the G-7 as the regular, not just crisis management, leaders' forum.

Pitfalls to avoid

There are two significant pitfalls to avoid.

1) The grandiose global super-regulator.

This won't fly because governments will not cede national sovereignty. Nor should they since, to be effective, regulators need to be very knowledgeable about the institutions they oversee. A global regulator fails this test. Size and reach cannot make up for the necessary proximity and focus and would very likely have negative unintended consequences.

2) Too much government intervention.

There is a tendency during a financial crisis to emphasise instability and unfairness over the growth benefits of open capital markets. Cross-country studies show that countries with deeper and more sophisticated financial systems have grown faster because capital can be allocated more efficiently. Individual welfare is also promoted when households can obtain credit to smooth their consumption requirements through time. The costs of the current crisis are associated with the deficiencies of governments and national regulatory systems, most recently in the US, not with liberalised and open financial markets.

Increased government ownership of banks and financial institutions was essential to their rescue. Yet unless governments sell down their stakes in a timely way in the

months and years ahead, we can expect to see bureaucrats and politicians substituting for the market in picking winners and losers and intervening in bank strategies and daily decision making. We will also see governments in key emerging markets maintain their ownership and control of bank-dominated financial systems – an outcome that would perpetuate the high cost of capital for small entrepreneurial growth enterprises that banks shun as business that is too risky.

Crises will happen again: Listen to IMF warnings next time

Finally, we should have no illusions. Financial institutions will continue to innovate and financial regulators will continue to be one step behind. When regulators and the IMF warn of impending problems during the next boom, politicians and market participants should listen and regulators should act in timely ways. But will they?

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East Asia's Self-managed Reserve Pooling Arrangement and the global financial architecture

Yung Chul Park

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The G20 leaders should recognise the stabilising role that Europe's regional financing arrangements play in the global structure and encourage the completion of a corresponding arrangement in East Asia. G20 nations should collaborate to make the SRPA a credible regional lender. This requires enlarging the SRPA's reserve pool, ensuring that attached policy conditions are no more stringent than the IMF's SLF, and making the disbursement process straightforward and expeditious.

At the Beijing Asia-Europe Meeting (ASEM) in October, leaders pledged that they would "undertake effective and comprehensive reform of the international monetary and financial system in consultation with all stakeholders and the relevant international financial institutions including the IMF to help stabilise the international financial situation (ASEM 2008)."

What role is there for regional financial arrangements in the global structure? For example, could one building block of the new system be an arrangement like East Asia's Self-managed Reserve Pooling Arrangement (SRPA) that creates liquidity support among East Asian nations (the ASEAN nations plus China, Japan, and Korea)?

Why regional arrangements can help

There are several reasons to think that regional funding arrangements could complement IMF in enhancing efficiency and stability. One regional funding arrangement – the Eurozone and its predecessors – has already contributed to deeper economic integration of Europe and developed into a critical component of the international financial system. Many in East Asia believe they could replicate the experience.

A second argument concerns the IMF's institutional weaknesses. At least in East Asia, the IMF has not regained its credibility because it has so far refused to engage in frank and constructive dialogue with Asian stakeholders. Instead it has simply explained its errors in the 1997 Asian crisis with openness and humility (Takagi 2008). Another weakness is the IMF's limited resources; they are not large enough to make the IMF the lender of first resort, to say nothing of the lender of last resort. This is where regional lenders could help by joining forces with the IMF to provide additional funds for emergency lending. A third institutional weakness is that the IMF may simply have too much ground to cover given the wide differences among broad emerging and developing economies.

Countries in some regions may need more than the IMF's monitoring and surveillance services in managing their macroeconomic policies. In development financing, the role of the World Bank is complemented by a large number of regionally specialised development banks. By the same token, there is no reason why there should

be only one global monetary fund.

The third and perhaps the most frequently raised argument for creating regional financial arrangement is that they may be better adapted to managing a regional capital account or liquidity crisis than the IMF. The IMF appears to have learned the lesson that a capital account crisis requires emergency lending for resolution. The IMF is ready to lend, with a streamlined conditionality, "billions of dollars through Short-term Liquidity Facility (SLF) to support nations with a good track record in economic management hit by fallout from the global financial turmoil" (IMF 2008).

Although the SLF will enhance the IMF's role as a crisis manager, it should be noted that, when a crisis in a country originates in the capital account, policy coordination and exchanges of information among neighbouring countries are essential in preventing contagion. The IMF can monitor capital flows within and between regions and also the behaviour of market participants but it is difficult to imagine that it could establish close working relationships with individual member countries and coordinate their policies. As a crisis lender the IMF may also have to maintain an arm's length relationship with its members.

Can the SRPA play a role in the global structure?

Despite its potential, however, questions have been raised as to whether the SRPA can be a credible regional lender and hence viable building block for a new international financial architecture. In its current structure it is too small as a pool of reserves to be taken seriously by the market. The borrowing procedure is complicated and is tied to IMF policy conditionality if the borrowing amount exceeds a certain limit.

Few of East Asia's emerging economies will be able to pull through the crisis without considerable loss of output and employment. Some countries such as South Korea have suffered a large increase in capital outflows as foreign investors are shifting to high-quality assets such as US treasuries, liquidating their investments to deleverage and cover their losses back home. The flight to quality together with the gloomy economic outlook has generated an expectation of depreciation of currencies, inducing further capital outflows. At present, the only recourse to short-term US dollar liquidity is borrowing from the overnight interbank market. A vicious circle seems to be setting in. Although it was designed to support dollar liquidity to its members, the Bilateral Swap Arrangements do not offer any relief and the completion of the regional pooling arrangement, SRPA, remains uncertain.

How to make the SRPA work for East Asia

This danger can be pre-empted if the ASEAN+3 nations (ASEAN nations plus Japan, China and Korea) together with the US and the EU collaborate to elevate the status of the SRPA to a credible regional lender. For its part, ASEAN+3 should consider enlarging the size of the reserve pool to be taken seriously by the market. Given the large amount of reserves held by the members of ASEAN+3, the size of the SRPA could be doubled.

Policy conditions to be attached to SRPA loans should be no more stringent than those of the IMF's SLF. Most of all, the disbursement process will have to be relatively straightforward and expeditious.

For their parts, the US and EU could consider including the SRPA in the reform agenda for constructing a new international financial architecture.

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The New Bretton Woods agreement

Guillermo Calvo

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The crisis is spreading to the 'South'. To offset 'sudden stop' disruptions, multilateral lending capacity should rise fivefold. Credit lines, like those extended by the Fed to struggling nations, need to be paired with regulations to discourage capital flight, and capital controls more generally should be viewed as useful tools for particular circumstances. Finally, in the longer run, serious attention should be paid to the creation of new or extended common currency areas.

The last 30 years have witnessed a gradual phasing out of the original Bretton Woods institutions. The Fund, in particular, started to behave as the fire-fighter that reaches the fire at his own pace, mostly to help victims clear the debris. More worrisome, the Fund has jettisoned its role as guardian of the foreign exchange system, sometimes even supporting foreign exchange regimes that are mutually incompatible, such as Argentina and Brazil in the late 1990s, and Guatemala and El Salvador right now.

Here are some reflections inspired by recent experience, and a few broad-brush recommendations for a new agreement.

Background

International trade in goods and bonds has grown much faster than world GDP. However, financial regulation and liquidity support has remained essentially local.

The lack of effective global financial institutions was painfully felt in several emerging market and developing economies (the South) in connection with the 1997/1998 Asian/Russian crises. These crises brought about a dramatic growth slowdown in the South, and precipitous collapse in some of them. The Fed and the ECB lowered their interest rates when the crisis lapped over their shores, but it was too late for the South.

The subprime crisis, in contrast, was handled differently. It was tackled head-on by central banks that, unlike those in the South, could operate as lenders of last resort. The result has been much more positive. World output has decelerated but not collapsed, and for a while the South appeared to be totally spared. This offers prima facie proof, or at least hope, that governments can play a useful role in dampening the negative, real-economy impact of financial crises.

Hopefully, too, if the G7 continue to support the credit market, their economies might escape meltdown. The situation could be quite different in the South.

The South's fiscal and monetary authorities cannot "print" hard currency, and their attempts to refloat their economies – which are beginning to feel the effects of worldwide deleveraging – may end up in high inflation or balance-of-payments crisis. This has already led the Fed, the IMF and other multilateral organisations to offer liquidity credit lines and regular structural adjustment programs.

These institutions' agility is commendable, but one doubts whether they have the necessary funds and institutional makeup if recession spreads to the developing world. For example, the \$30 billion currency swaps extended by the Fed to Brazil, Korea, Mexico and Singapore represent, on average, only about 20% of those countries' 2007 holdings of international reserves (minus gold), as reported in the IFS. This share is highest for Mexico but it does not surpass 35%. Indeed, the combined gross loans of the World Bank and the IADB to Latin America, for example, represented less than 2% of the region's investment in 2007.

To help offset the effects of a 'sudden stop' like the one in 1998 – which would probably look benign relative to the one that might befall the South in the current crisis – it can be argued that loans from the World Bank and the IADB must become at least 5 times larger than their present levels.

Recommendations

1) The new Bretton Woods institutions should focus first and foremost on global macroeconomic and financial stability issues in order to generate conditions for sustainable growth.

There is no institution in charge of those issues. The present crisis is teaching us that such institutions are critical for sustainable growth and, I dare say, for peace.

2) There is also a role for those institutions at the country level.

They could help to offset credit market distortions stemming from international sources (e.g., financial contagion). Local distortions are, of course, relevant but the comparative advantage of these institutions should be international. An example would be an Emerging Market Fund aiming at stabilising a bond market index like the EMBI.

3) Multilateral development banks should be prepared to increase their lending by a multiple of at least five times the current levels.

4) In the short run, Public-Private Partnerships (PPPs), supported by the G7, could be effective in sustaining growth in the South.

The G7 public sector embodies trust, while the private sector can provide most of the funding. Thus, the World Bank and other multilateral banks, which are supported by the G7, could be instrumental in generating PPPs. Effective PPP arrangements may help to lower the sizable capital that may be required by multilateral development banks to offset the present tight private-sector credit conditions.

5) Liquidity credit lines like the ones implemented by the Fed and the Fund are two-edged swords.

On one hand, they may help to stave off a currency/bank run. On the other hand, however, under worldwide deleveraging they could enhance the probability and size of a run.

To illustrate, suppose that the central bank employs a credit line to prevent a sharp rise in interest rates and currency devaluation. A multinational corporation (typically a prime borrower in developing economies' banking systems) scrambling for inter-

national liquidity, could short the domestic currency to buy sorely needed foreign exchange. In this case, the credit line would not have achieved its main purpose, and the country in question would have increased its public debt.

Credit lines should be accompanied by foreign exchange and banking regulations that limit the extent of capital flight.

6) The new Bretton Woods institutions should be more tolerant of controls on capital mobility, especially as those controls centre on limiting the actions of the banking sector.

7) Serious attention should be paid to the creation of new or extended common currency areas.

A system of freely floating exchange rates is faulty for the following reasons:

- As the case of Iceland illustrates, floating exchange rates can exacerbate financial fragility.
- Even institutions like the ECB, the Bank of England and the Bank of Japan benefited from the Fed's currency swaps, which would have no role if their respective currencies were freely floating with respect to the US dollar.
- Coordination of financial regulation and supervision – which is likely to be a prominent feature of the future financial architecture – may become extremely complex under freely floating exchange rates.
- As long as credit conditions remain tight, growth declines and unemployment rises, there will be strong pressures for competitive devaluations.

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A New Bretton Woods system should curb boom and bust

Vijay Joshi and David Vines

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Today's crisis has roots in a risky international monetary system as well as a risky financial system. Current international monetary arrangements encourage boom and bust cycles. G20 leaders should aim to build a system that induces nations to manage their macroeconomies in ways that produce neither financial bubbles nor large external imbalances and inappropriate exchange rates.

While some G20 leaders hope the November 15th Summit will lay the foundations for a 'New Bretton Woods', many are sceptical and we share this view. The 1944 Bretton Woods Conference was preceded by three years of difficult discussions among the US, UK, and other nations.

The G20 leaders should start a process that will eventually produce agreement after the present crisis has subsided. At this meeting, they should lay out the essential elements of a new system. We argue that better financial regulation is only one of these elements.

The rollercoaster ride that the world economy has been on this decade has revealed a scandalously risky financial system. It has also revealed a risky international monetary system that encouraged boom and bust cycles. If the G20 leaders aim to build a 'New Bretton Woods' system, they will have to address more than financial regulation. Since current international monetary arrangements tend to fuel instability, the new system must also address monetary arrangements.

A boom-and-bust international monetary system

An important feature of the rollercoaster ride was excess savings, especially in East Asia. For example, in Indonesia, Korea and Thailand, investment fell by 10% of GDP after the Asian financial crisis, and has stayed down. China's savings outstripped its already very high investments. The excess savings were translated into current account surpluses since sterilized foreign exchange intervention kept exchange rates undervalued. All this made sense for the individual nations. It allowed them to accumulate reserves as insurance against a 1997-style crisis and it fostered export-led industrialisation.

Asian excess savings were greeted by American cheap-money policies. US interest rates were cut from 6% to 1¾% in 2001, then cut further to 1% and remained exceptionally low for three years. The result was colossal housing and asset price bubbles, and very large current account imbalances, with the dollar's reserve-currency status aiding and abetting America's ability to run massive trade deficits. All this made sense for the US. The US interest rate policy was an understandable, even necessary, response to prevent Asian excess savings and current account surpluses from causing a recession in the US and the rest of the world.

The rollercoaster, as we all know now, was destined to end in a crash. The asset bubbles burst in 2007 and over-leveraged borrowers went bankrupt. Today we are witnessing the dire consequences for the world's real economy. It has become painfully clear that the dysfunctional incentives in the financial sector played a key role in inflating the bubble, but the unintentional consequences of the uncoordinated macro policies in Asia and the US are what started the rollercoaster rolling.

Fixing the global monetary system

The global crisis that we have had could thus have been averted only by a different monetary system. That is one essential task for any new Bretton Woods.

The new system should induce nations to manage their macroeconomies in ways that produce neither financial bubbles nor large external imbalances and inappropriate exchange rates. This is entirely possible as nations could pursue three objectives (the control of inflation, the preservation of financial stability and the avoidance of excessive international imbalances) with three policy instruments (monetary policy, regulatory supervision, and fiscal policy).

Interest rates could manage aggregate demand with the aim of keeping inflation low and unemployment at sustainable levels. Exchange rates would float, so a country with excessive inflation would raise interest rates and allow the exchange rate to appreciate, while one with too little demand would lower interest rates and allow exchange rates to depreciate. Countries could be required to regulate their financial systems so as to limit speculative risk taking. Finally, countries could use fiscal policies to keep spending and output sufficiently in line to avoid excessive external imbalances.

How to enforce virtue

The virtuous policy trio we have outlined would not be self-enforcing, as this decade's rollercoaster ride so clearly demonstrated. One version of the 'New Bretton Woods' – one which would require far stronger global governance than the G20 leaders seem likely to accept – would have the IMF enforcing all three elements. A more sovereignty-friendly version would more closely resemble the original Bretton Woods system in that it would only restrict exchange rate misalignments.

Such a system might be enough to induce countries to pursue the virtuous macroeconomic policies described above. For example, excess Chinese savings without an exchange rate that supported a trade surplus would have produced a recession in China – perhaps triggering a Chinese policy response that would have expanded domestic demand. Likewise, overspending in the US without the huge trade deficit would have produced an overheated economy and a demand-dampening US policy response.

This system would require the IMF to determine the appropriate exchange rate values for countries – 'fundamental equilibrium exchange rates'. The IMF would then be given the power to require countries not to intervene in such a way as to steer their exchange rates away from these fundamental values.

This would be coupled with a new system of provision of international reserves – in which it would be agreed that the IMF would regularly issue SDRs to all countries and also be given the power to make emergency issues of SDRs to fight crises. That would make it unnecessary for countries to seek to run current account surpluses to accumulate foreign reserves for insurance reasons. The US, in turn, would be less tempted to overspend, since it would lose the "exorbitant privilege" of issuing the

world's reserve currency.

This global monetary system would also imply a loss of sovereignty, in two ways. It would limit the ability of countries, including emerging market economies, to set their exchange rates in ways which harm the rest of the world. It would also limit the ability of countries that issue reserves, in particular the US, to run excessive deficits. But it would also limit the incentives for countries to act in these ways.

It will be impossible to get agreement on a major role for the IMF, of either of the above kinds, unless the Fund inspires trust and confidence. That in turn will need a root-and-branch reform of its governance structure to reflect the changing realities of the world balance of economic power.

Is it possible?

One might object that agreement on surveillance, of either the strict kind or the weaker kind, will be difficult to achieve. It will make inroads into national sovereignty. But the current system, without effective surveillance, will continue to make boom-bust outcomes likely. That too would be very costly, as we have seen recently.

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Targeted improvements in crisis resolution, not a New Bretton Woods

Erik Berglöf and Jeromin Zettelmeyer

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The current crisis reveals two major flaws in the world's crisis-resolution mechanisms: (i) funds available to launch credible rescue operations are insufficient, and (ii) national crisis responses have negative spillovers. One solution is to emulate the EU's enhanced cooperation solution at the global level, with the IMF ensuring that the rules are respected.

Big global crises always trigger calls for big global reforms. This time is no exception. Before G20 leaders embrace big-reform calls, they should look carefully at what happened the last time around.

When the last global crisis hit a decade ago, we saw a round of calls for big global reforms, including new institutions, new funds and new financial instruments that were touted as stabilising capital flows and allowing countries to insure against sudden stops. Other recommendations focused on bigger and better crisis lending, and on better international bankruptcy mechanisms.

While many of these ideas were good, virtually none of them were implemented. Instead, the victims of the crisis – emerging markets – reacted unilaterally; they sought to shield themselves from similar shocks in the future by building large foreign exchange reserves, reforming their financial sectors, etc.

Many of the G20 nations are currently making unilateral adjustments to shield themselves from future crises; this is a good and inevitable reaction. The G20 meeting, however, should focus on two systemic issues:

- The lack of IMF lending capacity, and;
- Negative spillovers among the unilateral responses, i.e. the fact that one nation's solution can become another nation's problem.

IMF lending capacity

For all but a handful of giant economies, the proper response to a global crisis requires outside help. As in the Asian crisis, IMF funds are insufficient to launch credible rescue operations. The current resources of the IMF would be sufficient to put together credible rescue packages for no more than a couple of emerging market countries if the crisis were to hit them with full force. Funds to increase the IMF's war chest should at least in part be raised from the large emerging economies. After all, they would benefit the most from improved insurance. In exchange, they should also get greater say in the institution.

Negative spillovers from national responses

The second major shortcoming of existing crisis resolution mechanisms is the nega-

tive spillovers of national crisis responses.

This problem is not new either, but it has become more apparent as interdependencies have increased and the number of packages has multiplied. Western governments have stabilised their own banking systems, but often at the expense of emerging economies.

Generous guarantees attract deposits from, and trigger runs in countries without the resources to back up such guarantees. Bailouts often impose restrictions on the support banks can provide to their foreign subsidiaries. The result could be the undermining of banking systems in many emerging markets.

These discriminatory practices should, of course, be forbidden. The IMF already does so in countries that benefit from its programmes. But most countries now bailing out their banks and guaranteeing their depositors do not need the IMF. One solution would be to give the IMF, or the Basel Committee, broader jurisdiction, but for this to be credible emerging economies – the main victims of these practices – must be better represented in the design and enforcement of the rules.

Ultimately, even these seemingly small improvements in crisis resolution mechanisms may require bigger reforms.

The regional route

But one possibility would be to start at the regional level. The negative spillovers are largely a European problem due to the extraordinary penetration of West European banks into Eastern Europe. If not all of the EU can agree on non-discriminatory practices, let a subset of member states pursue deeper collaboration on crisis resolution under the option of enhanced cooperation introduced in the Maastricht Treaty 1992 and spelled out in the Nice Treaty 2003. Members would subject themselves to bailout rules and perhaps even need to have certain institutions, like bank resolution mechanisms, in place before joining. The European Commission guarantees that the club would be open to any state that subscribes to its basic objectives and rules.

The obvious global approach would be to redraft the articles of the IMF to bring them closer in line with the more constraining spirit of the text originally signed in Bretton Woods. Unfortunately, such reforms are likely to be resisted by some.

An alternative would be to emulate the EU enhanced cooperation solution at the global level. In such a global club for crisis resolution the IMF could play a role similar to the one played by the European Commission in ensuring that the rules are respected. With a set of transparent requirements for joining, like the Maastricht criteria, this proposal could also help address remaining weaknesses in the institutions for crisis prevention in emerging – and mature – markets.

Author's note: These views are those of the authors writing in their private capacity and do not necessarily represent those of the EBRD or EBRD policy.

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Save Doha to save the G20 Summit

Ernesto Zedillo

Yale University, ex-President of Mexico

A meaningful agreement that starts to reduce the world's global economic governance deficit is simply not possible at the G20 meeting. But the G20 Summit need not be a disappointment. Plan B should be to save the Summit by saving the Doha Round.

Under the threat of a brutal financial and economic collapse, G20 leaders will meet in Washington on November 15th with the aim of addressing the lack of adequate global economic governance. Despite having been an early supporter of a similar idea, I am not optimistic about the outcome of the upcoming meeting. Building a global public good, as the Bretton Woods summit did in 1944, requires both the surrender of sovereignty and immunisation to the temptation of free riding – both of which involve many thorny issues. It is simply not possible to produce a blueprint for comprehensive reform with a few weeks' notice. Expectations that a sort of new "Bretton Woods" will be agreed are totally misplaced.

The world cannot afford to miss this opportunity

Nevertheless, I believe that it would be a shameful waste of a huge political opportunity if leaders limited themselves to creating a secretariat for planning the next meeting and instructing their bureaucrats to speculate about the future – as some have suggested is the only realistic outcome. The world cannot afford to miss the opportunity to do something meaningful to prevent the very real risk of catastrophic damage to the global economy.

Restrain protectionism and clinch the Doha talks

There is no doubt that even in the best of circumstances, a sharp global slowdown driven by painful recessions in some of the major economies of the world is now inevitable, and perhaps even necessary to correct the global imbalances and other excesses that are very much at the root of the crisis.

But the now unavoidable drama would become an unprecedented tragedy if countries started to fall into the protectionist temptation as a response to the crisis. Although it's been said ad nauseam, it is worth recalling how brutally autarkic instincts emerged in the 1930s and how vast was the resulting destruction of wealth, income, employment and even human lives.

The G20 Summit is the right place to exorcise the demons of protectionism. Already, there are proposals for leaders to make on November 15th a trade pledge – to avoid protectionism as an answer to the recession.

Frankly such a pledge will not suffice. Leaders will have to be bolder if they really mean to pre-empt the threat of trade wars.

The November 15th gathering would truly become a historical and successful one if leaders were to clinch right then and there the political agreements that are needed at the highest level to conclude the Doha Round.

Three incorrect analyses

Some commentators believe that the WTO's rules-based system – something that did not exist in the 1930s – makes the risk of a protectionist wave practically nil in this crisis.

Others have even proposed to give up on the Round simply because so much has changed since it was launched.

And then there are others who think that aiming to conclude the Round soon is too ambitious (after all, they argue, rather than serious agreements, the trade talks have delivered one breakdown after another despite having been launched seven years ago).

I strongly disagree with the three camps.

To those who think that the available trading system can prevent a spurt of protectionism, let's remind them that:

- A majority of the WTO members still have big differences between their bound and effective tariffs;
- Agriculture has been brought into the system in a quite imperfect manner; and
- Countries more frequently than not have tended to abuse the WTO provisions on contingent protection (e.g. antidumping tariffs) and standards.

There is thus lots of room for additional "legal" trade barriers.

To the total or partial sceptics of Doha, I would say that, although perhaps modest relative to the high aspirations at Doha's launch, the results achieved at the talks up to now are quite substantial. The sceptics should recognise that, despite a lack of political impetus from their leaders, negotiators have gone a long way toward narrowing differences in crucial and contentious issues such as market access and subsidies in agriculture, and further liberalisation in non-agricultural products.

Statesmanship on November 15th

Admittedly, serious disagreements still remain; otherwise the recent July breakdown of the talks would not have happened. But let's not forget that at the end of the day – and I can attest to this from practical experience – the final contentious aspects of good trade deals cannot be resolved by negotiators alone. Finishing the deal requires vision, courage and diplomatic skill by national leaders.

That is what statesmanship is about and precisely what has been missing all along at the Doha Round until now. Statesmanship should be brought into play at last to triumph on November 15th.

Problems that can be solved with political will

There is no lack of fair ideas to solve the pending conflictive issues. There is no reason why problems such as sensitive and special products and safeguards in agriculture, and the formulas to further liberalise and address sectoral initiatives of non-agricultural products, could not be solved if there is enough political will and muscle to make prevail, not the agenda of particular interest groups, but the long term benefit of each nation. In order to close the Round, leaders would also need to send to the

WTO built-in agenda a number of issues that are certainly sensible for some countries but not as crucial for the system as a whole. And, of course, countries at the G20 should keep in mind, and reasonably accommodate, the concerns of those that will not be present at the meeting. In particular they should commit substantial resources towards the long promised but not yet accomplished "aid for trade fund" in order to support poor countries in addressing adjustment costs associated with the implementation of the Doha Round. The rich countries should also pledge to reinforce their respective social compacts to make enhanced trade integration more palatable to their own people.

Despite its timing, the G20 Summit need not be a disappointment. The Plan B to save it is none other than saving the Doha Round.

About the author

Ernesto Zedillo is Professor of International Economics and Politics at Yale University, where he did his PhD in economics, and Director of the Yale Center for the Study of Globalization. He was elected President of Mexico (1994-2000), guiding the nation through the 1997/8 financial crisis and bold democratic and electoral reforms that opened the door to greater political pluralism. He has held several positions at the Central Bank of Mexico, including Deputy Manager of economic research, General Director of the trust fund for the renegotiation of private firms' external debt, and Deputy Director. He was Undersecretary of the Budget, Secretary of the Budget and Economic Planning, and Secretary of Education in the 1987-1993 Mexican government. Since leaving office in 2000, he served as Chairman of the United Nations High Level Panel on Financing for Development (2001) and is Co-Coordinator of the Task Force on Trade for the UN Millennium Project; was Co-Chair of the Commission on the Private Sector and Development, Co-Chairman of the International Task Force on Global Public Goods (sponsored by the Governments of Sweden and France), and is a member of the Trilateral Commission. With decorations from the Governments of 32 countries, including the Franklin D. Roosevelt Freedom from Fear Award, the Gold Insigne of the Council of the Americas, the Tribuna Americana Award of the Casa de America of Madrid, and the Berkeley Medal, UC Berkeley's highest honour.

The world is at a dangerous point. Governments and central banks have staunched the bleeding in their financial systems. They seem unprepared, however, for the next round of difficulties that will arise as the recession grows and financial crises spread to emerging markets. Economically and financially, there is a clear sense that things are spiralling out of control again.

The G20 meeting in Washington next weekend is an opportunity for the leaders to show that they have the will to solve the global crisis. This E-book collects essays on what the G20 should do. The authors – world-class economists from around the globe – identify four priorities for action:

- In the financial sector, act quickly, strengthen and coordinate emergency measures to staunch the bleeding; in the real sector, use fiscal stimulus to get the patient's heart pumping again.
- Act immediately to strengthen the ability of the IMF and other existing institutions to deal with the crisis in emerging markets.
- Start thinking outside the box about longer term reforms.
- Above all, do no harm.

Political conditions are not propitious, yet the state of the world economy is too delicate to wait. An empty declaration that shows our leaders are unable to agree on priorities will tell investors that the future will resemble the recent past. The wrong outcome from this meeting could damage the world economy rather than repair it.

The authors are: Alberto Alesina, Erik Berglöf, Willem Buiter, Guillermo Calvo, Stijn Claessens, Paul De Grauwe, Wendy Dobson, Barry Eichengreen, Daniel Gros, Refet Gürkaynak, Takatoshi Ito, Vijay Joshi, Yung Chul Park, Raghuram Rajan, Dani Rodrik, Michael Spence, Guido Tabellini, David Vines, Ernesto Zedillo and Jeromin Zettelmeyer.

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