Asia and the G20

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From the Editor’s desk

The establishment of the G20 is a change to the international system of an order that can be compared with the establishment of the great postwar international institutions. The G20 is now the premier forum for global economic governance following its elevation to leaders’ level meetings after the global financial crisis. The United States has led a smooth transition in the locus of power from the G7/8 to the G20.

The membership of the G20 is recognition of the importance of Asia in the global system. Now that Asia has this global platform, can it deliver on its global responsibilities? This issue of the Quarterly presents contributions from across the region to address some of the big questions that face Asia in the G20.

There are clearly Asian interests in the G20, although the region brings diverse perspectives and agendas to the global table, as it should. And how well Asian members of the G20 can project broader regional interests and engage non-member support for those interests and agendas is another question. The legitimacy of the process will ultimately depend on getting the answer to that question right. But there is resolve in Asia to make the G20 work, since there is a collective Asian interest that this global initiative succeed and continue. That encourages the G20’s Asian members to define a constructive agenda through which to contribute to the international public good.

The spotlight is on Korea as the first Asian and newly emerged economy to host the G20.

The remarkable achievement of the G20 in helping to steer the global economy out of the worst of the financial crisis thus far has consolidated its global role. But many risks remain.

The global economy remains unbalanced, because there is imbalance in major economies themselves. The way out is difficult and requires important structural adjustments at home for most countries. Asia can help to lead by example.

Asia can help the world by helping itself in advancing vigorous structural and financial reform, strengthening domestic safety nets, rebalancing growth and showing leadership and flexibility on policies that affect others, including on exchange rates, as well as by promoting global institutional reform, for example, within the International Monetary Fund and World Trade Organisation.

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The Seoul Summit: agenda and implications

Il SaKong

The global community quickly responded to the worst global financial and economic crisis since the Great Depression through unprecedentedly strong, concerted policy actions primarily led by the G20. Thanks to these efforts, the global economy was able to avert another Great Depression, although it could not avoid a Great Recession.

Since their first gathering in Washington DC in November 2008, the G20 leaders have met four times—Washington DC, London, Pittsburgh and Toronto—to combat the current global crisis. In the process, the G20 has proved its effectiveness by delivering outcomes which are deliverable and producing concrete implementable measures. With these achievements, the leaders in Pittsburgh designated the G20, which produces more than 85 per cent of global GDP and is home to two-thirds of global population, as the premier forum for international economic cooperation. Indeed, this was an historic event in terms of reshaping global governance to reflect the changed economic reality.

At the previous four summits, the G20 leaders put emphasis primarily on combating the crisis. At the same time, their concern was mostly on the priorities of the advanced countries where the crisis originated. The G20 so far has been effective as a crisis-management committee. As the sense of crisis recedes, however, the unity

Korean President Lee Myung-bak: the host country envisages a growth-oriented development strategy to achieve sustainable global growth.
among the G20 countries may also dissipate. In this regard, the outcome of the Seoul Summit will be highly critical for the G20’s future.

The agenda of the Seoul Summit can be dissected into two parts: follow-ups and additional items. The follow-up agenda includes four issue areas. First, it is the macroeconomic coordination which involves the Framework for Strong, Sustainable and Balanced Growth. After the first stage of the Mutual Assessment Process (MAP) in Toronto, the second stage is underway in Seoul to produce specific policy options for individual countries.

The second follow-up area is about International Monetary Fund (IMF) reform. The G20 leaders in Pittsburgh agreed on a 5 per cent shift in the IMF quota from over-represented countries to under-represented dynamic emerging economies as an effort to make the IMF more legitimate and credible. For the credibility of the G20 and the IMF, it is critically important for the G20 to complete the quota reform as promised by the Seoul Summit.

Recently the Basel Committee on Banking Supervision agreed on a new capital framework for banks which will be submitted to the leaders in Seoul for endorsement. I am quite sure that the G20 leaders in Seoul will endorse the new framework. The new framework distinguishes itself from both Basel I and II by including a macro-prudential regulatory aspect. So we might consider naming it as the ‘Seoul capital framework’ or ‘Seoul capital accord’.

Regarding trade issues, the G20 leaders in Seoul should be more forthcoming in resuscitating the Doha Development Agenda (DDA). This is absolutely essential for the G20’s credibility as the premier forum for international economic cooperation.

Korea, the first non-G7 country to host and chair the G20 Summit, proposed to include new agenda items specifically to address the needs and priorities of non-G20 countries, most of which are developing and emerging economies. It fits well within the Framework for Strong, Sustainable and Balanced Growth. The leaders approved the inclusion of economic development for low-income countries and the strengthening of the global financial safety net on the Seoul agenda.

Alleviating poverty and narrowing the development gap are essential to achieving sustainable global growth. The aggregate demand gap left by the advanced world can also be filled with additional global demand from the emerging and developing world. Against this backdrop, Korea envisions a growth-oriented development strategy. The G20’s newly established Development Working Group is expected to submit multi-year action plans to the leaders in Seoul.

A strengthened global financial safety net will help to reduce the incentives for emerging and developing countries, particularly small open economies, to generate current account surpluses to accumulate foreign reserves as self-insurance against volatile global capital flows. So it will help global rebalancing as well. The IMF, in cooperation with Korea, recently announced the first stage of strengthening the global financial safety net through enhancing the Flexible Credit Line (FCL) and introducing the Precautionary Credit Line (PCL). The second stage involves the establishment of the Global Stabilisation Mechanism (GSM), which is a framework for proactive provision of financing to stem contagion during a systemic crisis. The second stage also involves linking it up to regional cooperative arrangements, such as the Chiang Mai Initiative (CMI), to supplement and complement the IMF’s global financial safety net. The discussion is likely to continue into the next year’s summit in France.

The current global recovery, although fragile, has been primarily driven by government spending and public expenditures. For strong and sustainable global growth, however, it is crucial to provide enabling conditions for full participation by the private sector. In light of this, Korea is organising a Business Summit for top global business leaders to discuss the global recovery and beyond. Four to five top CEOs from each of the G20 countries and some non-G20 countries have been invited, totalling around 100 or so business leaders. Their discussions will centre on four main topics: trade and investment, finance, green growth and corporate social responsibility. The Business Summit being organised is an ongoing process, not a one-off event. The process is already underway to prepare their report, to be presented to the sherpas’ and finance ministers’ processes to be reflected in the leaders’ communiqué. We would like to see it become an additional pillar of the entire G20 Summit process in the future. In this regard, we are in close consultations with France, next year’s chair of the G20.

The Seoul G20 Summit is a litmus test for the G20’s future as the premier forum for international economic cooperation. Once the G20 in Seoul proves itself by keeping up to its earlier commitments, the G20 can then formally consider its further institutionalisation.
Catch-22 for the G20

WENDY DOBSON

THE G20 Seoul Summit will be the first such global economic meeting to be hosted by a non-G7 country. In their continued focus on the significant agenda for collective action set at Pittsburgh in September 2009, leaders face a catch-22. The tension and political uncertainties generated by subdued growth are weakening the collective will to cooperate on the policy changes needed to restore confidence and future growth.

To the continuing agenda—global recovery, rebalancing growth, financial regulatory reform and governance reform at the International Monetary Fund—the Korean hosts have added two new issues: financial safety nets and closing the development gap.

Progress on financial regulatory reform is clear. US and UK leaders, at the crisis epicentre, must respond to visceral public anger towards banks, the activities of which severely damaged the real economy to the extent that full recovery will take years.

There has been some progress, such as regulators raising the amount of capital banks must hold to cope with future bad debts. Nevertheless, additional measures are still needed to get taxpayers off the hook for future financial rescues and resolve problems in institutions with extensive cross-border ties. At Seoul, leaders will add a capital surcharge on the largest banks. Taken together, these actions will leave banks with smaller profits and less free capital to invest.

Banks will be safer but will another financial crisis be prevented?

Continued financial innovation suggests the answer is ‘no.’ Already there are signs of financial activity migrating beyond regulators’ reach to the ‘shadow’ financial sector of hedge funds and private equity players.

With little time remaining before the Summit there is more to do on other issues. The argument over IMF governance reform must be resolved. And the central task of rebalancing global growth requires political will and an agreed process of peer review.

The IMF’s mutual assessment process got off to a good start at the Toronto summit in June by mapping out needed changes. G7 governments engaged in a similar exercise in the 1980s, using the IMF to prod them along with its technical advice. Current IMF credibility is damaged by its perceived role in the Asian crisis. Leaders have restored its financial resources sufficiently for it to provide financial safety nets, but its support of the mutual assessment process is analytical. A more active role could help move rebalancing along. At Seoul action is required, as the G20’s credibility is at stake.

A Bank of Canada study in September this year shows a $7 trillion potential shortfall in global economic output by 2015 if G20 governments fail to cooperate on adjustment and leave it to market forces. Current account surplus countries agreed at Toronto to shift reliance from foreign to domestic demand through such measures as infrastructure spending, changing the incentives for households’ precautionary saving and increasing exchange rate flexibility. Political will is needed to cooperate rather than self-insure by managing exchange rates and accumulating foreign exchange reserves. Bilateral tensions between the United States and China over their adjustments (a credible plan for fiscal consolidation in the US and more exchange rate flexibility in China) do not help.

G20 credibility is on the line for another reason as well. It is remarkable that trade does not appear on the Seoul agenda.

Yet what could be more important to closing the development gap than completing the Doha development round at the World Trade Organisation to expand market access for developing countries selling into growing world markets?

Trade specialists can identify a package of measures that would conclude Doha. The issues are sufficiently technical that leaders cannot intervene directly. But they must give the go-ahead to complete the package. The five key players—the United States, Europe, China, India and Brazil—are all G20 members. Major political transitions or elections scheduled in a number of countries in 2012 suggest that a unique window of opportunity is open to complete the
negotiations in 2011. It will then close soon thereafter.

The catch-22 for Seoul is that leaders who should give more weight to the global interest are preoccupied with their own political issues. Determined leadership by the summit chair could change this.

President Lee Myung-bak should pick up the phone or get on a plane, whatever is required, to twist arms and encourage agreement and action on the pressing issues, balancing interests sufficiently to conclude the Doha round, and policy changes that will rebalance global growth. A smaller outcome in Seoul not only increases the chances of more crises but suggests the G20 is a talk-shop when it comes to preventing them.

About the G20

Formed as the Group of 20 Finance Ministers and Central Bank Governors in 1999 to provide a forum for consultation and cooperation on the international financial system.


Together, G20 economies cover 85 per cent of global Gross National Product, 80 per cent world trade and two-thirds of the world’s population. Organisationaly, the G20 chair rotates annually among members. There is no permanent secretariat or staff, but instead the chair sets up a secretariat for the duration of its term to coordinate activities and organise meetings. Continuity of the group’s work and administration is ensured by the cooperation of past, current and future chairs.

Members: Canada, Mexico, United States of America, Argentina, Brazil, China, Japan, South Korea, India, Indonesia, Australia, South Africa, Saudi Arabia, Russia, Turkey, France, Germany, Italy, the United Kingdom, the European Union.
Towards a new world financial architecture

TAKATOSHI ITO

The G20 includes more Asian countries than any other global grouping, and it is expected to be a good forum for Asian countries to press their agenda.

The G20 Summit was created out of the chaos of the global financial crisis. After Lehman Brothers collapsed in September 2008, global financial markets went into a tailspin. Securities markets were frozen as buyers disappeared. European governments, and the United States, had to de facto nationalise large, systemically-important financial institutions. In order to map out strategies for recovery, it seemed necessary to involve large emerging market economies, as they had become important contributors to rebalance growth. Even before the crisis, global economic weight had shifted towards large emerging market economies, like the BRICs (Brazil, Russia, India and China).

The G20 is now regarded as the ‘steering committee’ of the world economy, replacing the G8. It was first created as the Finance Ministers and Central Bank Governors’ Meeting in 1999, in the aftermath of the Asian Crisis; hence the increased Asian participation.

In the midst of financial panic following the Lehman Brothers’ failure, leaders of major countries called for a framework to discuss important financial issues among concerned countries. Leaders of France and Germany, and Britain, were quite vocal in pushing for the creation of a summit that would involve not only the G8 but also large emerging market economies. Some leaders called for G8 plus BRICs, while others called for an even broader grouping. Due to lack of negotiating time, leaders grabbed the existing G20 grouping, transforming it into a leaders-level Summit.

At first, it was not clear whether this would be a permanent institution. After three meetings, it was decided to make the G20 Summit permanent. It is often advertised as a grouping that comprises 85 per cent of world GDP.

In the G8, Japan was the only Asian country, whereas China, Japan, Indonesia, Korea, Australia and India all participate in the G20. On the one hand, having six Asian countries is a good start for pushing the Asian agenda at the conference. On the other hand, the group of 20 countries may be too big to act in a timely way. Voices as well as votes are important. Whether the G20 continues to be an important ‘steering committee’ on international financial issues is still unclear, and the Korean G20 Summit will set an important precedent for perceptions of Asian capabilities.

The G20 Summit has been effective in crisis management and building new financial architecture. Several agreements on monetary and fiscal policy commitment, and an agreement on anti-protectionism, were made. For example, coordinated fiscal stimulus and monetary stimulus, in the face of decline in aggregate demand, were encouraged at the Washington Summit, although a quantitative target was not adopted. In addition to growth and employment, recommendations also included reform agendas for international financial architecture, including an International Monetary Fund quota adjustment; resources (loans) for the IMF; tripling Special Drawing Rights (SDR) allocations; and transforming the Financial Stability Forum into the Financial Stability Board.

In order to see how the G20 compares with other groupings, the table on Page 10 shows the correspondences between GDP share and ranking in the world economy; IMF quota share; and memberships of G8, G20, General Arrangements to Borrow (GAB) and New Arrangements to Borrow (NAB). GAB and NAB are the financing mechanism for the IMF if it needs liquidity for its own lending to crisis countries.

The membership of the original
G20—that is, the Finance Ministers and Central Bank Governors Meeting—was chosen to reflect GDP size rankings, with some consideration for regional representation. In response to the criticism of Asian countries regarding their low representation when the G20 was originally created in 1999, European countries were given less emphasis and countries from Asia and other regions were chosen. European countries, like Spain, the Netherlands, Poland, Sweden, Switzerland and Belgium, were not chosen, while Korea, Indonesia, Turkey, Saudi Arabia, Argentina, and South Africa were.

The contrast with G8 and G10 membership is clear; the G20 has more Asian countries and emerging market economies. In this sense, the G20 is closer to a balanced representation than the IMF quota or the GAB. The list of countries participating in the NAB is broadly similar to the G20 list, with the notable exception of emerging market economies, namely the BRICs and Mexico.

Because the G20 acted in crisis mode, its decisions were quick. Also, the composition of membership—less weight on European countries—may have contributed to faster decisions. China seems to have recognised the importance of voicing concerns and disseminating ideas about how new international financial architecture should be shaped. For example, Governor Zhou Xiaochuan of the People’s Bank of China gave three speeches in late March 2009. They were titled: ‘Reform the International Monetary System,’ ‘On Savings Ratio,’ and ‘Changing Pro-cyclicality for Financial and Economic Stability’.

The timing was clearly chosen for the G20 meeting in London that April. The first speech stirred debates in international finance circles, and in the third Governor Zhou argued that SDR should be used more extensively, as a liquidity provision in case of crisis, and that SDR composition should be revised. While he was not explicit, it would not be surprising if China requests consideration for the RMB to be included in the last session for the year.

This has produced the impression that China is effectively using the G20 to press its own agenda. It remains to be seen how Korea will use its chair position to push its own agenda.

Japan has been conspicuously absent from hot debates regarding reforming global financial architecture, and agenda-setting in the G20 Summit process. Perhaps Japan is absorbed
by its internal political mess, and does not have the time or capacity to contribute to global leadership.

Asia collectively is not pushing its agenda, if there is one. An Asian G20 caucus does not exist. So far Asia remains fragmented despite the opportunity increased membership presents.

After so many years of under-representation in the IMF, Asia has not coordinated to maximise its effectiveness. But, one may wonder, is there a common agenda for Asia? Asian leaders should examine whether Asia collectively has anything to contribute to the global agenda, or an Asian agenda to press. ASEAn also demands that the ASEAn Secretariat be granted permanent observer status, if not full G20 membership.

Asian countries should think carefully how ASEAN, ASEAN+3, ASEAN+6 and other Asian meetings should be used to give input that can be advocated by Asian members in the G20. If Asia fails to conduct preparatory meetings and coordinate its agenda, Asian voices risk falling upon deaf ears.

The G20 Summit will most likely continue as the premier institution of global governance concerning financial markets. Financial markets will repeat boom and bust cycles in the future too. If a crisis in Asia should occur again in the future, Asian voices should prevent a repeat of the mistakes of the Asian financial crisis of 1997-98. Asian economies will continue to grow, and their collective economic weight continues to increase. So why not coordinate a collective voice? This is the challenge that Asian leaders will face.

### The G20 and other groupings (world economy rankings)

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GOVERNANCE AND PRIORITIES

The global agenda: a bigger role for Asia

MAHENDRA SIREGAR
AND TUTI W. IRMAN

The unprecedented level of policy coordination by G20 countries in responding to the global financial and economic crisis in 2008 was instrumental in preventing the worst economic downturn since the 1930s. It is still too early to say that the crisis is over, but at least we can safely say that it could have been much worse if the G20 had not acted swiftly. This success was the most important reason why the Summit of heads of state or government in Pittsburgh decided that from then on the G20 would be the premier forum for international economic cooperation—an historic decision from the perspective of global governance as well as the role of Asia in the global economy.

Does the G20 offer a new approach to global governance?

G20 members hold 85 per cent of world GDP, 80 per cent of international trade, and represent two-thirds of the world’s population. However, unlike the G7, where all of the members are from developed countries, half of the G20 members are developing countries. This is a major shift in global economic governance. There was a strong sense of realism at Pittsburgh. Advanced economies accepted that to prevent the global crisis from deepening, major efforts to rectify the global economic governance were required, and that these efforts would not be effective without the support of emerging economies. This signalled the importance of emerging economies as well as the pressure on them to share the burden and responsibility for solving the world’s most urgent problems.

The G20 is undertaking a landmark overhaul of the Bretton Woods institutions, the International Monetary Fund and the World Bank. The most important change will be to balance the voting rights between the over-represented advanced and under-represented developing nations in these organisations. Not only has the G20 itself created an unprecedented new level of global governance, but it is accepting a new level of responsibility in reforming the governance of other international organisations.

G20 members have presumed the right to determine the group’s direction, agenda and priority issues. At the Toronto Summit, development issues were set as a priority in its future agenda. Developing-country members of the G20 have successfully made this a priority as ‘representatives’ of all developing nations, not only from concern about their own problems. The ability to set the agenda creates an opportunity to extend the reform of global governance beyond the international financial and economic agenda.

The G20 has developed significantly since the second half of 2008, when the global economic crisis prompted the Washington summit to be convened. Formerly a forum of finance ministers and central bank governors, the G20 group has been elevated to summit level just one decade after it was established. With 20 members from around the world, including ten emerging economies, the G20 has the right balance when it comes to levels of income and international representativeness. The group’s credibility is underpinned by its political and economic leverage, since it has the power and authority to make effective and practical decisions.

Reforming global economic governance is one thing; commitment to secure global policy coordination recovery is another. This new challenge is well captured by the Seoul Summit theme, ‘Shared Growth beyond Crisis’, but it remains to be seen how the G20 can deliver on commitments across a range of strategic global issues within the context of the existing platform of global cooperation. The fact that six G20 states—Australia, China, India, Indonesia, Japan and Korea—are members of the East Asia...
community highlights the region’s strategic importance in global governance. The region is also one of the world’s most dynamic and includes two of the world’s largest economies in terms both of nominal GDP and purchasing power parity. With rapid economic growth over the years and trade surpluses with the rest of the world, Asia’s foreign exchange reserves are estimated at $4 trillion, or more than half the world’s total. Asia had been the most resilient region during the global financial crisis. These factors position the region as the most important engine of the global recovery.

The region’s role as an engine for global recovery and growth, and its long history of regional engagement, encourages the notions of an informal regional sub-grouping in the G20, and moving regional integration to the next level. But there are many challenges that have to be dealt with first. Countries in the region have to showcase their abilities in sustaining high economic growth, maintaining political stability and working towards closer regional integration. An approach that relies on a politicised and formal structure will not suit the dynamics in a region which is economic growth-oriented and market-driven.

The East Asia region has assumed a more important role in the G20 era. Whether or not particular countries in the region are members of G20, there is a now a need for East Asia as a whole to focus on that bigger role, accepting more responsibility on global issues beyond its ‘regional comfort zone’.

An approach that relies on a politicised and formal structure will not suit the dynamics in a region which is economic growth-oriented and market-driven.

The Asian region is one of the world’s most dynamic and includes two of the world’s largest economies. PICTURE: AP / AAP
FILLING THE POLICY VACUUM

Asians can think: a time for Asian leadership

BARRY CARIN AND PETER HEAP

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BSERVING the G20 scene from a North American country with pretensions to an Asia-Pacific vocation, we are reminded that over 10 years ago, Kishore Mahbubani, Singaporean UN Ambassador, wrote the book Can Asians Think? Mahbubani provocatively questioned Asian acceptance of Western leadership and paradigms, and Asian tolerance of the West’s condescending attitudes. Prompted by Mahbubani’s insights, we wonder why Asians continue to acquiesce to outdated, ineffective global institutions designed by Westerners more than 50 years ago in very different circumstances.

Why does Asia assent to the US Federal Reserve as the de facto ‘world financial authority’ and the US Treasury Secretary as the de facto head of the International Monetary Fund? Why does Asia seem resigned to bear disproportionate costs in bailing out OECD countries’ financial institutions? Why does Asia tolerate OECD agricultural subsidies of hundreds of billions of dollars and resign itself to accepting the World Trade Organisation’s intellectual property regime? And why does Asia tolerate the continued existence of the G8?

More generally, why does Asian reticence prevail, given the recent financial regulatory disaster, the ongoing lack of economic growth, the futility of climate change and trade negotiation deadlocks, the perils of nuclear proliferation, and the clear evidence of stalled development demonstrated by the failure of the Millennium Development Goals? Western models and existing institutions have obviously failed across the board. A Martian would conclude that on Earth, the borrowers run the international financial institutions, the polluters manage the environment and the inmates run the asylums.

A key opportunity has arisen for Asia to redress the balance in global decision-making processes. In November South Korea will be the first Asian host of a G20 Summit. After a disappointing Toronto meeting, which neither moved the substantive G20 agenda forward nor contributed to the evolution of the G20 institutionally, the Seoul Summit is positioned to do both.

Asia’s weight within the G20 is significant, consisting of six major countries—China, Japan, India, Indonesia, South Korea and Australia. Combined with natural allies such as Brazil, Argentina, Mexico, South Africa and Turkey, Asian G20 countries should be in a position to drive the G20 process. We remain puzzled that the leading states in the region have not stepped forward to lead the effort to make the expanded G20 a more effective body which finally moves the international centre of gravity away from the traditional ‘western’ powers. If ever there was a time for the emerging economies to shed the legacies of colonialism and the Cold War, this is it. Can Asia and its allies devise a credible and practical set of goals and strategies to re-imagine the structure of international relations?

Realistically, the US will remain a major actor for the foreseeable future. A key element in this strategic thrust is the China-United States axis which sits at the centre of the reoriented global configuration. Asia must build off the power of this dyad to achieve its objectives. Impetus from China is particularly important at a time when the US political system seems likely to remain in deadlock at least until the 2012 presidential elections. A Chinese role as energiser and conceptual pioneer would be extremely useful.

Despite diversity, one issue where we may reasonably expect a coherent Asian strategy is with respect to Europe. The fulfilment of the G20’s promise requires both Europe to give ground and Asia to lead. An obvious target of opportunity is the over-representation of European

How long will Asia continue to send thousands of containers of goods to the West in exchange for depreciating paper?
countries in the G20 (and by extension throughout the international system). Europe is essentially a disunited paper tiger in terms of meaningful global power, incapable of effectively mobilising its economic and military potential. Europe is the weak sister in terms of the G20 commitments to multilateral co-operation. The EU maintains significant effective trade protection in the form of subsidies, bailouts, ‘buy national’ injunctions and restrictions on foreign direct investment. The EU has done nothing in practical terms to promote achievement of the Doha Round or free up investment flows.

Europe has used the G20 as an expedient means of tapping into emergency funds pertinent to the EU’s own interests, rather than as a step towards broader and more balanced multilateral cooperation. The largest share of the bailout funds agreed by the G20 has been directed to states in Europe.

The profligate US is another villain—incapable of regulating its own financial sector, running two wars without taxation, and over-consuming and dissaving on the backs of Asia. How long will Asia continue to send thousands of containers of goods to the West in exchange for depreciating paper? Why not insist on turning the Special Drawing Right into an alternative reserve currency, allowing a gradual withdrawal from the addiction to the US dollar?

Influencing G20 outcomes requires aggressive pursuit of the moral high ground when it comes to shaping the work programs and operating procedures of key international bodies such as the IMF. With political gridlock in the US (a country manifestly incapable of even ratifying treaties) and feebleness in Europe, Asia and its allies need to move in to the policy vacuum and use the G20 to institutionalise broader and more inclusive approaches to global decision-making.

ROWTH can no longer be generated from the West on the back of emerging economy surpluses, but will need to come from within the emerging world itself. Asian countries must devise the means to move away from a reliance on export-oriented economic policies. The IMF has done little to soften the impact of the crisis in developing countries and still lacks legitimacy, yet is being mandated with powerful new surveillance functions by the G20. Under these new rules, will the EU and the US subject themselves to the same degree of oversight that the IMF has long visited upon developing countries? Based on historical experience, this seems very unlikely.

Asia, which now holds the strong cards, must caucus to promote initiatives such as: the final burial of the G8, with its questionable practice of inviting developing countries as second-class citizens; establishing a formal G20 secretariat located in Beijing; establishing a formal Asian Global Fund, open to South Americans and Africans as well; and, setting up an Asian regional trade organisation—to press the OECD countries to reduce the billions in agricultural subsidies.

With the Seoul Summit, if this is to turn out to be the Asian century after all, the legitimate concerns and aspirations of the Asian region must be brought to bear on the proceedings of the G20. It is time for Asian countries to step forward and promote their national and regional interests. The world as a whole would be better off for it.
Recovery and growth: the opportunity for Asia in the G20

PETER DRYSDALE AND SOOGIL YOUNG

The most important outcome of the G20 will be the reassurance of strong commitment from G20 leaders to macro-economic recovery strategies and to the structural changes needed for balanced growth and sustained development in the long term. As the most dynamic in the global economy, Asian economies have an especially important role in setting out the course ahead for rebalanced and sustainable growth.

The recovery of some industrial economies is still fragile and will require continuing expansionary measures, within the bounds of debt sustainability (which are a greater constraint for Europe). International Monetary Fund (IMF) projections show that global current account imbalances will rise for some time as growth recovers in the period to 2015. With US unemployment still above 9 per cent, Asian economies must rely less on the US consumer for final demand and more on domestic and regional demand as Asia continues to increase in importance as a growth pole in the world economy. In much of Asia and the other emerging economies, strong growth will require moderation of government spending to allow private spending to accelerate without inflation.

Averting worldwide depression in 2008 was made possible by the major economies working together to re-start their economies and refraining from systematic resort to protectionism or competitive devaluations. Their action created the confidence needed to stimulate demand sufficiently to avoid a depression, through setting fiscal and monetary policy appropriate to national economic conditions.

In 2010 leaders can agree to continue the coordination of policies, informed by the work they commissioned from the IMF. The IMF’s Mutual Adjustment Process (MAP) scenarios set out two vastly different prospects for employment and living standards in the next five years:

- either weak recovery, and a second wave of recession, with poor coordination of macro-economic policy settings;
- or a sustained recovery from the global financial crisis, with rising employment, if G20 governments adopt an approach that is coordinated around rebalancing growth.

Sustained and balanced growth will need to be backed by leaders’ commitment to carefully calibrated macro-economic policies, including exchange rate policies and structural change policies, that maintain confidence in markets at the same time as they address the fundamental causes of imbalance in national economies as well as the global economy.

Correcting imbalances will require continued macro-economic policy adjustment and fiscal and structural reform in both countries with current account deficits and those with current account surpluses. In countries with current account surpluses, of which there are in several in Asia, the priority should be on substantial restructuring, which strong capacity for growth both allows and recommends for national development. While current account surpluses are falling in key Asian economies, it will be important to avoid their growing again. Asian members of the G20, drawing on their own past experience and success, can help to set ambitions for structural reform and change that are crucial to achieving more balanced and sustainable global growth.

Two key lessons are, first, that rebalancing strategies will not succeed if they are one-dimensional—they need to involve a suite of
complementary policy measures—and, second, they take time to implement. There are no simple measures that can make large imbalances disappear rapidly. But establishing confidence in the direction of change will restore the confidence of investors, consumers and bankers that the recovery is sustainable.

One vital component of policies for rebalancing growth is structural reforms that strengthen domestic demand and improve productivity though measures such as:

- strengthened social safety nets, including pension and health insurance programs;
- enhanced physical infrastructure that reduces supply bottlenecks to sustainable growth;
- reform of factor markets to remove distorting subsidies to industrial production; and
- investment in the engines of sustainable long-term growth, such as energy and resource efficiency, renewable and clean energies, green transportation and cities, quality-of-life services such as health care and sanitation.

HOUSEHOLD demand can be expected to expand as wages rise, labour mobility is enhanced and households are provided with capital income-generating opportunities. The structure and timing of particular reforms will depend on each country’s economic circumstances and institutions.

A second important component is exchange rate policy and greater exchange rate flexibility. Increased exchange rate flexibility is necessary in order to encourage relative price shifts between tradable and non-tradable activities and economic rebalancing. Exchange rate flexibility will assist in shifting the economy towards more productive use of resources and make it easier to control inflation and to manage external shocks. Asian experience in the 1980s and the 1990s shows that major Asian economies have a strong national interest in deploying increasingly flexible exchange rate adjustment for these tasks, along with supportive monetary policy. The structure and timing of such reforms will depend on each country’s economic circumstances and institutions and is correctly a matter for national policy decision.

Recent suggestions for a multilaterally agreed exchange rate realignment do not suit present circumstances. Indeed, very large one-off exchange rate changes would likely disrupt trade and currency markets and could threaten the stability of the international monetary system.

The idea that exchange rate realignments should alone carry most of the burden of correcting national and global economic imbalances is seriously misguided will sensibly constitute one part of a package of policy measures available to governments.

Effective coordination to underpin future stability of the international monetary system could be undermined by asymmetrical adjustment between deficit and surplus countries. While current account deficit countries cannot sustain their deficits and are forced to run down their reserves or depreciate their currencies, surplus countries can find it politically convenient to maintain nominal values of exchange rates and run up foreign exchange reserves. Cooperative action to avoid this is highly desirable—and it will depend on surplus countries having more say in, and having confidence in, international monetary arrangements. IMF governance reform is essential to building this confidence.

On the question of making financial market regulation more effective and robust, Asia could make a positive contribution to strengthening global financial system governance by establishing a functioning Asian Financial Stability Dialogue (AFSD) that draws in the whole region and complements the work of the Financial Stability Board (FSB). This would add to the work of building confidence globally in financial market regulation.

THE task of avoiding a second round of recessionary pressure on the international economy induced by trade or currency measures highlights the importance of using the window of political opportunity that exists in 2011—before major political transitions in a number of countries scheduled for 2012—to complete the Doha Round. The Seoul agenda needs to underscore the centrality of trade policy to recovery and development. The Doha Round has dragged on
for far too long. At Seoul, leaders can agree on a balance of interests and direct negotiators to complete the Doha round as soon as possible and no later than the end of 2011. The time has come to give trade ministers permission to conclude the round to lock in the gains already available. They can then address the issue of World Trade Organisation (WTO) reform. Its negotiating modalities and the problem of bilateral and regional arrangements are not subject to effective discipline, so that they serve core global trade objectives at a critical time for global trade openness. Repositioning the WTO so that it can deal with all dimensions of contemporary international commerce is central to the G20’s development agenda.

THE G20 provides the opportunity for Asian economies to address all these and other problems that need global solutions. Asian economies need to decide how best to take up these issues through the G20, especially by putting forward options which support and complement the interests of other regions. Conscious that the G20 process will work most effectively if there are clear priorities given to the discussion of major issues, it will be helpful to flag and position issues of importance to the region for future meetings and give fuller consideration to issues of global priority through regional meetings.

An early opportunity to establish productive interaction between the global and regional processes is the Yokohama APEC leaders summit immediately after the G20 Seoul Summit. APEC leaders can link the pursuit of their five-part growth strategy to G20 priorities, with emphasis on rebalancing growth. Careful thought needs to be given to how Asian members of the G20 can best link their participation in trans-Pacific and East Asian regional arrangements to their individual responsibilities in the G20 and to the representation of broader regional interests. How regional structures should develop or be reorganised to serve these purposes is an important issue for further consideration.

Digest of report from the Asia G20 Roundtable.

G20 protesters in Seoul. The Summit provides an opportunity for Asian economies to address a range of problems that need global solutions.
A testing time for the G20

ANDREW ELEK

Two years ago, the global financial crisis was the catalyst that brought the emerging economic giants to the global table, promising a new world economic order.

Agreement on simultaneous stimulus and sustaining openness was in marked contrast to the uncoordinated policies of the 1930s. A looming global depression was avoided and this early success has allowed the G20 to claim the right to supplant the G7/G8 as the steering committee for the global economy.

The new forum now needs to shore up its legitimacy to represent the rest of the world, determine its priorities and pursue them in a credible way.

After just a few meetings, G20 communiqués are becoming longer, with nice words about an ever-wider range of important matters, while not committing participants to do very much. This combination risks a loss of credibility and salience, but can be avoided.

The new forum should not attempt to compel participants to make specific policy decisions. But a voluntary process of cooperation can be effective if it concentrates on just a few vital issues and is able to achieve a perceptible policy convergence on how they are addressed.

Orchestrating a coordinated response to the global financial was important, but at least two urgent issues remain: international macroeconomic rebalancing and limiting climate change.

A more sustainable pattern of global demand and supply will not be achieved easily. It will need structural reforms to change incentives for saving and investment in all economies. A consensus is emerging for strengthening both domestic and international safety nets. The International Monetary Fund has already launched a Precautionary Credit Line (PCL) to reduce the need for large national foreign exchange reserves.

It will be harder to establish consensus on sharing the burden of...
limiting greenhouse gas emissions, where short-term national interests diverge and negotiations will be hard. After the disappointment of Copenhagen, eyes are turning to the G20, but that is not the place for negotiations. If G20 leaders failed to negotiate policy convergence, the forum would lose credibility; if they succeeded, the forum would risk losing legitimacy as the rest of the world questioned its right to negotiate on their behalf.

A more viable approach is to focus on principles and modalities for getting climate change negotiated globally. These might include: reaffirming the shared commitments to limit temperature rise to 2 degrees; financial incentives for producers and consumers to adopt less carbon-intensive habits; and convergence toward equal emissions per capita by an agreed date, such as 2050.

Endorsement of these guidelines would increase the prospect of successful negotiations in existing and accepted international organisations.

A principles-based approach, ideally backed by setting positive examples and cooperation in policy development, can be applied to other issues. While acknowledging that the slow pace of reforms on any issue are limited by domestic political realities, G20 participants can exert peer pressure to implement policies in line with guiding principles. They can commit to frank reporting—to each other, not for communiqués—on what they have been able to achieve and to share their experience of successes and setbacks.

The G20 will also need to help raise living standards for economies not at the table. The challenge is to make it possible for all economies to follow the examples set in East Asia where many economies have integrated in the global trading system and reduced poverty substantially. The key is ever-deeper engagement in global production networks, while avoiding over-reliance on external demand. Individual governments bear most of the responsibility for implementing the reforms that are needed to achieve this outcome, but the G20 can help in at least two significant ways.

One of these is to promote international commerce based on the fundamental international economic insight that products and factors of production should be compared on the basis of price and quality, not on the ownership or location of suppliers.

The remarkable sustained increase in prosperity of the past 60 years could not have been achieved in a world split into rival trading blocs...
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Consensus, compliance and the limits of legitimacy

GARY HAWKE

The G20 has been widely welcomed, but so far it has had little impact. If it should become effective, its legitimacy will become contested.

Members of the G20 are more or less the 20 largest economies in the world. The criterion is arbitrary but not unreasonable. G20 membership is much more inclusive than that of the older G7 and G8. It is less dominated by North America and Europe than its predecessors. The inclusion of China, India and Brazil greatly enhances the legitimacy of its claim that it speaks for the major economies of the world.

The G20, however, has no basis in agreed treaties. It is not part of the United Nations system and it has no distinct legal basis. That is not unusual, as many international organisations rely on voluntary compliance. This imposes constraints on the ability of the G20 to create rules which can be applied to non-members—or for that matter, to dissenting members.

What then can the G20 legitimately do?

First of all, it provides an opportunity for leaders to share experiences as well as an opportunity to engage in bilateral meetings to pursue their own agendas. We should not underestimate the significance of confidence-building through personal relationships, nor should we expect too much from merely adding another occasion on which it can be practised.

The G20 provides leaders with an opportunity to submerge their domestic agendas in a wider common endeavour. One of the major contributions of APEC was that it encouraged unilateral reform. Participants were assured that criticism could be counteracted by evidence that on a wider international basis, similar actions had been taken elsewhere. This does not lead to positive evaluations when commentators try to distinguish between the effects of APEC separately from the effects of multilateral or unilateral action, but it is nevertheless a positive contribution. It is essentially the ‘Alcoholics Anonymous’ impact in which participants know perfectly well what they should do and that they themselves are best placed to do it, but benefit from the mutual support available through occasionally gathering with others facing the same problems. The G20 widens the group sharing this experience, and we can expect benefits for both those who were members of G7/G8 and those who were not.

The G20 provides an opportunity for participants to resolve disagreements. The record so far is limited—G20 statements repeat the familiar more than they demonstrate progressive resolution of issues. For example, there was no statement on improving the performance of rating agencies beyond the obvious that it would be desirable to do so. The G20 could barely close the gap between European reliance on more regulation and US wishes to allow tailored over-the-counter derivatives. These derivatives are to be traded among sophisticated investors while requiring standardised contracts and exchanges (which permit tracking of risk incidence) for other investors. The G20 has done nothing to generate understanding of the extent to which the global financial crisis could be attributed to a ‘savings glut’ rather than policy errors in developed economies. Still, these are early days.

The principal impact from meetings of leaders is often that they set a timetable by when real work has to be completed. The APEC Economic Leaders’ Meeting has long had this principal purpose, although it has escaped most media commentary. The East Asia Summit (EAS) has set

Non-members will demand that they be allowed a voice on important deliberations and will challenge the ‘legitimacy’ of any claimed agreements on which they have not in some way been consulted.
timetables for both the work of the Economic Research Institute for ASEAN and East Asia (ERIA) and for working groups towards an East Asian Free Trade Agreement and the Closer Economic Partnership of East Asia. How this will work with greater US and Russian engagement in the EAS has yet to be seen. There is little equivalent to the G20 beyond ad hoc groupings, and one of the big issues for the G20 is how it will interact with regional organisations, international financial institutions, and regional development banks to develop such an agenda.

In these respects, the ‘legitimacy’ of the G20 rests essentially on consensus. The G20 is influential because of the size and significance of its members. Non-members will demand that they be allowed a voice on important deliberations and will challenge the ‘legitimacy’ of any claimed agreements on which they have not in some way been consulted.

A DIFFERENT kind of ‘legitimacy’ is involved if the G20 should claim an ability to impose requirements on simply anybody. Non-members will especially question any type of coercion. There is no link to the treaty basis which is the eventual basis for United Nations processes. Enforcement mechanisms may be indirect. Compliance with international banking norms and processes, for example, may rest mostly on access to certain banking resources. Also, compliance with international accounting standards may rest most on desire for access to US capital markets. Surveillance through customary international law is slow to evolve and slow to respond to particular issues.

We may well be sceptical for quite a while of the likelihood that the G20 will agree on anything which looks at all coercive. We can be content with seeing a wider body of world leaders contributing to the evolution of international processes and norms. The ‘legitimacy’ of the G20 in any attempt to go further will rest essentially on its ability to motivate and accept input and support through regional organisations in implementing any agreed processes.
Non-Member States

Providing a voice to ‘excluded’ nations

ISHRAT HUSAIN

The formation of the G20 grouping of finance ministers and central bank governors and their heads of state is indeed a significant improvement compared to the previous G8 arrangements. The dynamic changes in global economic output and international trade are adequately reflected in this expanded group. The inclusion of 10 emerging economies such as South Africa, Mexico, Argentina, Brazil, China, South Korea, India, Indonesia, South Arabia and Turkey in the consultative process has broadened the scope of the dialogue. But it still excludes 170 nations from direct participation in this forum. Norway, one of the major donors to development programs, has protested that it has no voice within the group.

The questions of the legitimacy, representative character, governance structure, voice and accountability of the G20 remain and pose certain dilemmas for countries such as Pakistan which do not have a seat on the table. While it is true that the number of seats in this organisation should remain limited to ensure the effectiveness and continuity of its activity, the lack of transparency in the process and the choice of the countries invited to become members of the group causes some serious concerns.

The forces of globalisation are spreading so widely and rapidly and the importance of international public goods is becoming so palpable that a new international governance structure is needed. It is not obvious that the G20 can fill this gap. For example, the issues remitted to the finance ministers of the G20 by their leaders at Pittsburgh involve areas such as a framework for strong, sustainable and balanced growth, reforming the mandate, mission and governance of the International Monetary Fund (IMF), development banks, an open global economy, modernising our global institutions to reflect today’s global economy, and others. Each one of the 170 excluded countries or economies has direct interest in these issues which are going to affect its future directly or indirectly. The interests of the majority of countries are neither taken into account nor given due weight in the decision-making process.

Let us illustrate this problem with the example of Pakistan—the fifth most populous country in the world, enjoying the same per capita income as its next door neighbour, India. The size of the Indian economy is eight times that of Pakistan and naturally India, on the basis of its economic strength and dynamism, was invited to become a member of the G20. If the political relations between the two countries were cordial and there was a convergence of national economic interests then it is quite conceivable that Pakistan could use India as a proxy for its representation at G20 forums. But the fact that the two countries suffer from a serious ‘trust deficit’ precludes this particular possibility.

Where does this leave Pakistan? Any reform of the IMF, or multilateral development banks or setting up of new global institutions would affect Pakistan. How does it ensure that no damage is inflicted upon it under any future arrangement and in fact it is a beneficiary of the decisions taken to reform global institutions?

Assume that the composition of the IMF and the World Bank’s executive boards is altered, replacing nine of the 24 seats belonging to the European Union. Will this result in automatic takeover by the 10 members of the G20? Wouldn’t these countries argue that their economic prowess has already been established by their inclusion in the G20 and that therefore they are entitled to occupy the vacant seats? Won’t this platform be seen as a means of self-aggrandisement by some?

One option is the formation of constituencies consisting of various countries, as is the case with the IMF and the World Bank boards.
In the WTO Doha Development Round there are multiple groups among the developing and emerging countries each trying to project and safeguard their own parochial interests. These groupings do not stay intact when the global climate change discussions take place. A new set of alliances, networks, groupings are constantly formed and dismantled depending on the nature of the problem. Similarly, the simple dichotomous relationship between the developed and developing countries has also lost its meaning. In some instances, some developed countries do align themselves with some developing countries and in other cases they stay together as a bloc with other developed countries. In a multi-dimensional, multi-player environment, it is hard to predict which of the groupings or alliances would remain stable and for what period of time. The large eco-system has therefore become inherently unstable and therefore the governance structures such as the G20, with their selected, fixed sub-set of countries, are inadequate to address the requirements of the system.

What are the options available to the excluded countries such as Pakistan to have a voice at the G20? One option is the formation of constituencies consisting of various countries, as is the case with the IMF and the World Bank boards. Representation on G20 forums from each constituency would be on a rotational basis for a fixed term. Each country can select a constituency of its own choice from among the developed and developing countries. The other option is that 20 countries already included in the G20 should have formal consultative mechanisms with clusters of excluded countries (associate countries) whereby they solicit their input and advice, represent and articulate the interests of their associate countries and keep them informed about the decision-making process.

The above options, though not perfect, would overcome some of the apparent weaknesses of the existing arrangements. It will at least introduce transparency to the process of inclusion of countries, protect the interests of excluded countries, give a voice to the latter group and hold the membership accountable.
Leadership need not only come from the G7

JEFFREY FRANKEL

Korea has an opportunity to exercise historic leadership when it chairs the G20 meeting in Seoul. This will be the first time that a non-G7 country has hosted the G20 since the larger, more inclusive, group supplanted the smaller rich-country group in April 2009 as the premier steering committee for the world economy. With large emerging market and developing countries playing such expanded roles in the world economy, the G7 had lost legitimacy. It was high time to make the membership more representative. But there is also a danger that the G20 will now prove too unwieldy, in which case effective decision-making might then revert to the smaller group.

When countries like China and India used to demand a larger voice in world governance based on their large populations, they did not get very far. Substantive power in multilateral governance is allocated according to the Golden Rule: ‘He who has the gold rules.’ But after a few decades of miraculous economic growth rates, they now have the economic heft. China is now larger economically than Japan or Germany. Brazil is also one of the seven largest economies. Beyond GDP, we have recently seen an historic role reversal. Many developing countries, breaking historic patterns, took advantage of the global boom of 2003-2007 to achieve high national saving rates, particularly in the form of strong government budgets, while the advanced countries did not. As a result, the debt levels of the top 20 rich countries (debt/GDP ratios around 80 per cent) are now twice those of the top 20 emerging markets. A stronger fiscal position is why countries like China could afford large and sustained fiscal stimulus in response to the 2008-09 global recession. By contrast, the United States and the United Kingdom wasted the boom by running budget deficits, and by 2010 had come to feel completely constrained by their debts.

It is understandable if Korea views its hosting of the G20 as another opportunity for marking its arrival on the world stage (as when it hosted the 1988 Summer Olympics) or for consolidating its status as an industrialised economy (as when it joined the OECD in December 1996). But it must make more of the opportunity than this. Korea should seize the chance to exercise substantive leadership. Otherwise, the risk is that its period as chair could appear like a replay of the chaotic Czech presidency of the EU in the first half of 2009, which confirmed the feelings of some in the larger European countries that it was a mistake to let smaller countries take their turns behind the wheel.

Korea can serve as a bridge between the G7 and the developing countries. But chairing a successful meeting will be a challenge, with respect to both meeting management and substantive issues. With regard to managing the meeting, the challenge comes from the size of the group. There is always a trade-off between legitimacy and workability. The G7 was small enough to be workable but too small to claim legitimacy. The United Nations is the other way around. The latest evidence of this was the Conference of Parties of the UN Framework Convention on Climate Change in Copenhagen last December. The UNFCCC proved a totally ineffectual vehicle, in part because small countries repeatedly blocked progress. The G20 is still too big to be workable as a steering group. A principle of multilateral talk-shops is that conversation is not possible with more than 10 in the room. With 20 delegations, each reads its prepared statement; there is no give and take and the communiqué is a watered-down least-common-denominator press release. Not only does the G20 have more than 10 delegations; it actually has more than 20.

The G20 needs a smaller informal steering group within the steering group, a G6 or G9 within the G20. It could meet in the evening before the main G20 meeting and discuss how to organise the discussion in the larger group. Who would be in the G6 or G9? It would be unwise to be too specific at this point. Nevertheless, the US, Japan, and Europe must be there on the rich-country side; China, India, and Brazil must be there on the developing-country side. The pressure to expand is always irresistible. Europe could be represented by both the UK and Euroland. In Seoul, Korea has to be there as the host. Who would be the...
9th country in the G9? It should be the country of which the person reading this column is a citizen.

What about the substance of the meetings? The group will discuss whatever the bigger countries consider it most useful to discuss at the time. Five possible topics include:

- more reform of multilateral governance, particularly the International Monetary Fund executive board;
- financial regulatory reform, such as coordination of any small taxes or penalties that members want to apply to risk-taking banks;
- global current account imbalances (perhaps there could be a statement agreeing that exchange rates and budget deficits both bear some responsibility, and that the burden of adjustment should be born by neither one alone, but rather by both);
- macroeconomic exit strategies (the group could articulate the proposition that concrete steps toward long-term fiscal consolidation in each country need not require premature withdrawal of fiscal stimulus. An example would be to reform public pensions by increasing the future retirement age);
- a new agreement on climate change to take effect after 2012. Korea is in a good position to lead here, as it is essentially the first post-Kyoto-Protocol country to accept emission targets.

By the way, don’t judge the outcome of the meeting by what appears in the media. Press reviews will pronounce the meeting a let-down. They always do. But occasionally such meetings are important, in ways that are usually not clear until later.

Consider the London G20 meeting of April 2009. It was not obvious at the time that it had been a success in terms of substantive policies. Observers even compared it to the infamous failed London Economic Summit of 1933, a way of saying that the world had not learned the lessons of the Great Depression. But the 2009 meeting appears far better in hindsight. Fiscal stimulus turned out to be more widespread in 2009 than one might have guessed. Similarly, global monetary policy was easy, avoiding another big mistake of the 1930s. The G20 unexpectedly agreed to triple IMF resources. Even the trade policy outcome, despite fears of protectionism, was not bad by the standards of past recessions, let alone in comparison to the Smoot-Hawley Tariff Act of 1930. Overall, policymakers’ immediate response to the global recession in 2009 did not repeat the mistakes of the early 1930s.

Currently, however, the advanced countries are in danger of repeating the mistake that President Franklin Roosevelt made in 1937, when he cut spending prematurely and sent the US economy back into recession. Perhaps the G20 will be a venue in which the emerging market countries can remind the US and the UK of the lesson they once knew but have now forgotten—what it means to run a countercyclical fiscal policy.
In EAST Asia, as elsewhere in the world, the risks that we continue to face in recovery from the global financial crisis, not only economically but also politically, are a consequence of past failure in the architecture of international governance, including regional architecture, that frustrated a coherent East Asian and international response to the big problems of the day in their global context.

The global financial crisis and the emergence of the G20 has changed all this dramatically and gives Asia’s G20 members the opportunity to assume a new role and proper responsibilities in managing the world economic order. Korea has peculiar responsibility in the exploitation of this opportunity as host of the first G20 Summit in Asia in November 2010.

The G20 includes China, Japan, Korea, India, Indonesia, and Australia. These are the most important economies in the region and individually and collectively they represent an important new voice in global affairs. They are already exercising a measure of influence globally and the Seoul meeting offers the chance to cement their role as constructive players in the G20 process.

But there are other significant economies in Asia and growing regional integration also requires that their interests and policy approaches be brought on board if there is really to be both economic and political coherence in bringing Asia’s weight to the global table credibly and effectively. Regional arrangements have to be able to serve that purpose as a priority, as well as the other purposes for which they have been established.

How well can the established arrangements for regional cooperation in Asia be co-opted to support Asia’s participation in building a global economic system that is more capable of dealing with the big policy problems at the heart of Asia’s global and regional interests today?

This region’s unique mode of regional cooperation appears increasingly robust as a model for global cooperation through the G20, and in the face of difficulties and problems that attend other models of economic cooperation that have been exposed in Europe. The model is an asset which Asia brings to global cooperation in the G20, a process that must be managed without deep institutionalisation or the supranational legal authority that might ensure that member and non-member nations follow through on commitments.

Over the past 20 years, the relatively open trade and investment environment in East Asia has helped underpin growth and integration into the world economy. There are points of political tension, but the underpinnings of political confidence in an open regional economy have been steadily deepening. East Asia is now a force of stability and dynamism at a turbulent time in the global economy. And it is important to be absolutely clear that the evidence is that regional cooperation arrangements like APEC and the East Asian arrangements have mattered in securing this outcome.

Financial cooperation and trade policy are the areas on the economic front in which there is an immediate priority in strengthening institutional arrangements and policy strategies that connect more effectively regional action to global action.

On the issue of financial cooperation, an inward-looking set of arrangements that are delinked from global institutions are not in Asia’s interest, although some advocate delinking to intensify regional cooperation. Asia is already too prominent a part of the global system. The region does not have either the technical capacity or the political trust necessary for effective surveillance, monitoring and credible implementation of large scale support programs. The EU, where surveillance, cooperation and analytic capacities are well developed, cooperates closely with the International Monetary Fund in rescue packages for European economies.

The loss of IMF credibility in Asia at the time of the Asian financial crisis is not a reason to delink regional cooperation from global cooperation in finance but rather a reason for Asia to engage in the IMF and be a force for change. The G20 allows this.

Asia could make a positive contribution by establishing a functioning Asian Financial Stability Dialogue that draws in the whole region and complements the work of the Financial Stability Board. A question is whether this can or should be effected under the aegis of the East
Asian Summit (EAS) or the APEC Finance Ministers’ process.

On the issue of trade strategy, Asia’s position in the world trading system now puts it in the spotlight in managing the global trading system and who needs to shoulder the responsibility. Not so long ago, Asia could afford to be a free-rider in trade policy leadership. This is no longer the case. China is now the largest exporter and second largest trader in the world, the largest destination for foreign direct investment and the sixth largest source of foreign direct investment. Asia is already the second largest centre of world trade; by 2020 it will likely be the largest.

Structural reform is now high priority in Asia and is an issue on which Asia can contribute to the international agenda through the G20 process since structural reform is an essential element of Asia’s development experience and must be pushed forward to change the export-led growth model, correct international imbalances and sustain regional and global growth.

The structural reform agenda is much broader than the trade agenda and delivers much higher economic gains.

Multilateral and bilateral agreements do not deal with reform or liberalisation of communications (including ICT), transport, regulatory and governance institutions or other issues, for example, that are central to efficient integration into the international economy.

The structural reform agenda is central, therefore, to the shared objective of achieving more sustainable and balanced growth in our region. Continuing economic growth and deepening integration of the East Asian and Pacific economy requires reform of domestic institutions and regulatory systems. These regulatory and institutional reform issues are not susceptible to negotiation through traditional processes of trade negotiation, either through the World Trade Organisation or through free trade agreements.

On both these issues—how to re-position trade negotiation strategies to serve both regional and global objectives and how best to make progress in opening markets through regulatory and institutional reform—Asia will be expected to deliver.

Asia can show leadership, through commitment to reform of the WTO, through further opening up its markets, helping to conclude the Doha round, connecting and ‘multilateralising’ its web of FTAs, and promoting the structural reform agenda. Asia now has the forum at the global level, in the G20, to display this leadership.

Whatever is done to re-position Asian regional architecture so that it takes more account of, and connects with, Asia’s new role in global economic governance, as well as the implications of Asia’s rise for political and security affairs, needs to build on the foundations of established regional structures—APEC and East Asian arrangements.

There are two big gaps in the structure and operation of regional architecture. The first is its failure to connect to evolving global arrangements, including the G20 process. The second is that it does not yet encompass the political and security dialogues that are a necessary anchor in managing the impact on political and security affairs of the huge changes in the structure of economic power that are taking place in the region.

In principle, the first of these issues can be remedied relatively easily by the timing of regional meetings around the G20.

The second issue is one that leaders throughout the region have been struggling with in different ways. At the core of this issue is the development of a framework which might help to reduce the risk of a fracture in political confidence around the rise of China’s (and India’s) political influence alongside the established military and political power of the United States, consistent with growing East Asian economic cooperation.

The United States has pre-empted this issue by announcing that it wants to join the EAS and that is a move that ASEAN, strategically, was in no position to resist. It is by no means clear where this development will eventually lead nor that it will serve to mitigate the possibility of political tensions across the Pacific. Should the EAS become primarily a dialogue for political affairs without the ballast of economic dialogues to which the United States can effectively relate, that would likely exacerbate rather than calm trans-Pacific tensions. That ballast is currently lodged in APEC and that is not going to be changed quickly. There needs to be much careful thinking and more dialogue on this and the evolution of regional arrangements, beyond the Washington beltway, across the whole East Asian and Pacific region.

Developing these structures right so that they are representative of, and connect to, all the regional arrangements, and carry Asian interests constructively into the G20 process will be crucial to whether Asia becomes a pillar for entrenching the G20 process or eventually comes to tear it apart.

EAFQ
On September 29, the US House of Representatives passed a bill to punish China for its undervalued currency. For this bill to become actual policy, it requires endorsement by the Senate and approval by the President. But, with mid-term elections due for the House and the Senate on November 2, the currency tension between China and the US might temporarily ease somewhat.

Treasury Secretary Tim Geithner indicated during a Ways and Means Committee hearing before the House of Representatives that he would use the upcoming G20 Summit in Seoul to pressure China to accelerate pace of renminbi appreciation. There are some obvious benefits of using a multilateral framework such as G20 Summit for resolving a currency dispute. But a ‘Plaza Accord II’, if that’s what Geithner had in mind, might be a dangerous way to go.

Many government officials from G20 members have been busy for the past months defining a proper agenda for the G20 Summit in November. This is critical because otherwise the gathering would be a waste of the leaders’ precious time. More importantly, the relevance of G20 as an institution depends on its ability to solve global problems. Since inception of the G20 Summit, its legitimacy has frequently been questioned.

To be fair, the G20 already has a long list of items proposed for discussion among leaders in Seoul. Many are a direct extension of the efforts fighting the global financial crisis. They include creation of a policy framework supporting strong, sustained and balanced growth around the world, restructuring of the financial regulatory framework and reform of the International Monetary Fund (its voting power and governance structure).

For sure, the leaders would again have to discuss the issue of exit from expansionary fiscal and monetary policies. The Toronto Summit actually had an agreement on this but its implementation was complicated by worsening of the sovereign debt crisis in Europe and risks of a double-dip recession in the world economy. Continuation of excessively loose monetary and fiscal policies, however, could be poisonous for future growth.

Other issues proposed for discussion by experts and
policymakers are the Doha Round of WTO Trade Negotiation, anti-corruption, climate change and marine environment protection. These are all important subjects. The Doha Round, in particular, could play a vital role in containing trade protectionism and ensuring a open and free trade system. The difficulty, however, is that the leaders might not be able to deliver concrete results in the short term.

As the host of the Seoul Summit, the Korean Government has also added two items to the agenda: global financial safety net and development. But it's not clear if Korea intends to build a financial safety net completely independently of the reform efforts for the financial regulatory system and the IMF. Certainly, development of low-income countries is important both politically and economically. But what can G20 leaders deliver on all this in Seoul?

One area where the G20 can play an important role is global rebalancing. From its beginning in Washington in late 2008, the G20 Summit repeatedly stressed the importance of rebalancing as a way of both reducing financial risks and supporting sustainable growth. So far, however, we have seen very limited action from respective governments. This is understandable since global leaders have been busy containing financial and economic risks.

There is a wrong-headed perception among some experts and officials that the global imbalance problem is fundamentally a problem between the US and China. If that is the case, then the task of rebalancing should be left to these two countries and the G20 would have little to contribute. This is not consistent with the facts. True, China accounts for a large part of the global surplus. But similarly, Japan, other East Asian economies and oil exporters also contribute significantly to the overall surplus.

The global imbalance is a global issue. Resolution of it is better effected through multilateral frameworks. It certainly helps reduce risks of direct confrontation between the worlds’ two largest economies. The multilateral approach is also more likely to root out the core problem. For instance, even if China is forced to eliminate its current account surplus, the global imbalances may continue if other surplus countries do not do the same. The US might simply shift its borrowing from China to others.

But how should G20 deal with global rebalancing? The approach hinted at by Geithner through forced appreciation of renminbi is likely to be dangerous and unproductive. It might amount to a ‘Plaza Accord II’ as proposed by Bill Clines of the Peterson Institute of International Economics. In essence, a ‘Plaza Accord II’ would require currency appreciation and fiscal expansion in surplus countries but currency depreciation and fiscal contraction in deficit countries.

But ‘Plaza Accord II’ will probably be as ineffective as the original Plaza Accord, which did not eliminate the global imbalances. For instance, the US current account surplus as share of GDP was 1.7 per cent in the late 1980s, stayed at 1.6 per cent in the 1990s but surged to 4.7 per cent in the early 2000s. Princeton historian Harold James put it more bluntly: ‘The lesson of the past clearly indicates that a more sophisticated approach is required rather than exerting massive pressure for exchange rate adjustment and looser monetary and fiscal policy.’

‘Plaza Accord II’ is likely to be dangerous because it might force excessive on-off currency adjustment in surplus countries like China. Given the current state of the economy and the financial sector, drastic currency movements are likely to cause real difficulties. And any downturn of the Chinese economy today could risk growth and recovery from recession in many countries around the world, most notably East Asian economies and commodity exporters.

A better approach would be for G20 to focus on structural reform in key countries in which imbalance is a problem. And currency adjustment should be an important part of the policy solution, but not the whole solution.

The G20 could play a role since it is able to look at experience in different countries. It can also coordinate the timing of the structural reforms in respective countries, since the reduction of a surplus in one country inevitably leads to, or has to be accommodated by, the reduction of a deficit in another country.

Take the example of China. The large Chinese current account surplus derives mainly from distortions in factor markets, which repress costs of production and artificially improve the competitiveness of China’s manufacturing exports. Exchange rate misalignment is only a part of the picture of distortions. Elimination of the current account surplus requires liberalisation of the...
factor markets. Relying exclusively on currency adjustment to correct external imbalances would require an out-sized appreciation, and that would be difficult for China to accommodate at this stage, both politically and economically.

Likewise, the exceedingly low savings rate in the US before the subprime crisis was caused by a number of factors. Simply depreciating the US dollar by a significant margin is unlikely to lift the savings rate materially. Such currency moves threaten to destabilise the economy and financial markets.

For the G20 to play a positive role in global rebalancing, it would have to depart from the earlier approach of the G7 focusing only on exchange rate and fiscal policy. Instead it should make efforts to encourage and coordinate more broad-based structural reforms in both surplus and deficit countries, consistent with what was agreed by G20 leaders in September 2009 in Pittsburgh, namely:

- G20 members with sustained, significant external deficits pledge to undertake policies to support private savings and undertake fiscal consolidation while maintaining open markets and strengthening export sectors.
- G20 members with sustained, significant external surpluses pledge to strengthen domestic sources of growth. According to national circumstances this could include increasing investment, reducing financial markets distortions, boosting productivity in service sectors, improving social safety nets, and lifting constraints on demand growth.

The good news is that global rebalancing is already happening. Both the current account deficit in the US and the surplus in China as shares of GDP have shrunk by half from their respective peaks before the crisis. Obviously, part of these adjustments must be cyclical, given global economic recession. But the bulk of the decline in global imbalances from 2007 to 2009 was a result of countries rebalancing export and import growth, and that is more likely to be sustainable.

Again, taking China as an example, recent adjustment of its external imbalance was, at least to some extent, a result of changes in domestic factor markets. Factor costs have been on the rise despite the global financial crisis. This is most evident in labour and resource markets due to changes in both policies and demand-supply conditions. During the past year, the government has begun to reduce price distortions for most resource products in order to improve economic efficiency. The upcoming labour shortage is already pushing up wages by close to 20 per cent a year.

People’s Bank of China deputy governor Hu Xiaolian recently argued that adjustment of factor prices are an important way in changing the renminbi’s real effective exchange rate. Such price adjustments are bound to have an important impact on China’s trade composition. Rising wages, for instance, not only directly benefit consumption but also force labour-using industries to move inland, another important positive factor for promoting domestic demand.

These are the policy issues that G20 leaders should focus on, with flexible exchange rate regime as a part of the broad structural reform package. The G20 can help identify some best practices, defining target ranges, setting time frames and laying out some types of disciplinary mechanisms (such as taxes on excessive surpluses and deficits). But it is better to leave decisions on choices of policy instruments and the pace of implementation to national governments.
NEED FOR FLEXIBILITY

China’s exchange rate: the elephant in the G20 room

BARRY EICHENGREEN

As the G20 assembles in Seoul, it has a full plate. There is the need for continued progress on strengthening financial regulation—one on getting countries to harmonise their still-divergent approaches to regulatory reform and to push the Basel III reforms of capital adequacy through to their logical conclusion. There is the continuing inadequacy of international arrangements to wind-up insolvent cross-border financial institutions. There is the need to coordinate monetary and budgetary policies so as to reconcile fiscal consolidation in some countries with the need for continuing policy support from others for what remains a less-than-certain recovery. There is the need for agreement on the global financial safety net, the pet project of the Korean hosts. There is the need to push ahead with quota reform at the IMF and to agree on reducing the number of European seats on the fund’s executive board.

No doubt the G20’s communiqué will touch on all these areas. But there is also the elephant in the room, namely China’s exchange rate.

The G20 does not exactly have a record of issuing strong statements or achieving breakthroughs in this area. China has been reluctant to let its currency adjust significantly, the announcement last year of a change in its exchange-rate regime notwithstanding. And other G20 countries have been reluctant to push the issue. This G20 failing jeopardises the prospects for recovery.

The absence of progress on this front means that global imbalances will be back. Asia is still running current account surpluses and accumulating reserves. The European periphery, previously accustomed to running current account deficits, is no longer in a position to do so. This leaves only the United States on the other side of the equation. US households are saving more than before the crisis, but the country as a whole is not. The IMF projects the US external deficit as soon rising back to 4 per cent of GDP, and it may be overoptimistic.

The return of global imbalances would be worrisome for two reasons. First, imbalances, while not the entire explanation for the financial crisis, were certainly a factor in those events. Foreign capital inflows allowed the US to keep interest rates lower for longer than otherwise and encouraged investors to stretch for yield. Allowing those imbalances to return would not encourage the deleveraging that is needed to reduce financial fragilities.

Second, the growth of the US external deficit, against the backdrop of continuing high unemployment, raises the danger of protectionism. The Fed having spent its bullets and fiscal policy having been sidelined for political reasons, the pressure for US politicians to do something—anything—to encourage employment is intense. At this point, protectionism is the only lever available. Almost everyone would like to see the danger created by this sort of response averted. The question is how.

The answer is for China to allow its currency to rise more rapidly against the dollar. For a long time I’ve actually been on the side of cautioning against pressuring China to act. Letting the renminbi rise would slow the rate of growth of Chinese exports and shift domestic demand away from locally-produced goods. If nothing else changed, this would mean a growth slowdown for China, or worse. My view has been that China should let the renminbi...
rise very slowly as it gradually boosts domestic consumption through the development of financial markets and an effective social safety net, institutional reforms that can only take place slowly over time.

Now, however, the Chinese authorities are actively taking steps to cool off the economy, mainly by instructing the banks to tighten their lending standards. Growth rates accelerating to more than 11 per cent late last year and early this one raised the risk of overheating. They led to worries about a housing bubble. They created visible strains in the labour market.

Why not cool off the economy by shifting some Chinese spending towards imported goods, instead of the current strategy of reducing overall spending? And why not shift the composition of output away from manufactures produced for export and toward services produced for the home market?

The Chinese authorities still hesitate to go down this road. The source of their hesitancy is presumably a reluctance to mess with success—to tamper with a tried-and-true growth model. Evidently the United States is not the only country where politics stand in the way of the adoption of a sensible economy policy.

Why, then, does the rest of the G20 hesitate to push? There is an understandable caution about putting pressure on the world’s second largest economy, which has considerable capacity to push back. There is the tradition of consensual decision making within the G20. But if the G20 is incapable of taking hard decisions, then what is it good for? The rest of the communiqué will be easy. Whether it says something significant about China’s currency will be the acid test.

STRUCTURAL problems are controversial in China. The phrase ‘structural problems’ is used to refer to many economic imbalances in China: unbalanced growth between industry and the service sector; unbalanced growth between investment and consumption; unbalanced growth between different regions; the trade imbalance, worsening of the income distribution, and so on. Some Chinese economists argue that ‘structural problems’ are overstated because those imbalances are unavoidable, given China’s stage of development and demographics. By this line of thinking, those imbalances will be solved naturally when the Chinese economy matures. Other economists argue that imbalances are real ‘structural problems’ that are associated with serious misallocation of resources, sacrificed welfare, and weakening of China’s growth potential.

In my opinion, unbalanced growth should be divided into a good part and a bad part. The good part accelerates China’s modernisation, and will make China a wealthier country in a generation when it faces a rapidly ageing population. The bad part of unbalanced growth is most accurately labelled ‘structural problems’ for its negative impacts on sustainable economic and welfare growth.

Unbalanced growth between industry and the service sector, as well as unbalanced growth between investment and consumption, are two typical structural problems in China. Among a long list of imbalances in the Chinese economy, I conclude that the major structural problem is unbalanced growth between industry and the service sector viewed from the supply side, or unbalanced growth between investment and consumption viewed from the demand side. Imbalances from these different views, however, can be attributed to common ultimate causes. Fiscal policies subsidise investments in industrial sectors or exports at the expense of the service sector; industrial policies limit access of private capital into many service sectors that are monopolised by state-owned enterprises (SOEs); monetary and exchange rate policies form a rigid real exchange rate that fails to respond to changes in the trade balance. All these policies encourage development of industrial sectors, exports, and import substitution, and thereby increase the trade surplus; however, they undermine development of the service sector and domestic consumption. China’s trade
Imbalances and many other structural problems are results of a combination of such policies.

Chinese policymakers are aware of these structural problems and taking action. The components of the four trillion renminbi (Rmb) stimulus package launched after the global financial crisis can be seen as both smoothing economic growth and solving structural problems. The lion’s share of the stimulus package is aimed to improve public infrastructure. These investments will contribute to increasing domestic demand and improvement of people’s living conditions. In addition, reforms in many areas are under way, among them increasing protection of the labour force, encouragement of private investment in sectors traditionally monopolised by SOEs, acceleration of social housing construction, reforms in medical care, in Hukou (household registration system) and land policy reforms in some regions, a farewell to the RMB’s de facto US dollar peg regime, and reduction of tax rebates to exports in some areas.

Structural reforms challenge China’s conventional wisdoms and some interest groups, and cannot make significant overall progress in the near term. While the mainstream of policymakers and economists strongly supports the idea of structural reforms, and many reforms are under way in China, we can’t expect too much overall progress in the near term. Structural reforms require reforming of people’s thinking and a farewell to conventional wisdom, as well as requiring brave politicians and the sacrifice of some people’s interests. It takes time for people to learn, to understand, and to achieve consensus.

International pressure for RMB exchange rate revaluation is a dangerous way to solve structural problems. I, together with my colleagues, have argued for reform of the RMB exchange rate regime for many years, and still believe revaluation of the RMB to be beneficial for both China and the rest of the world. Unfortunately, we have as yet failed to persuade most of the people around us. This is understandable, as the consequences of this policy change will be complicated, and because changing this policy challenges the conventional wisdom of China’s growth model. I have to warn that the public, the policymakers, and the economists feel uncomfortable with pressure for RMB exchange rate revaluation from the international community, and may prefer to keep the exchange rate stable even at the expense of a trade war.

Avoiding a trade war and exploring long-term options for solving structural problems is in the best interests of China, Asia, and the international community in general. Foreign pressure to immediately revalue the renminbi reduces domestic Chinese political space for policy discussion and delays reforms. Furthermore, even if the Chinese economy could somehow immediately rebalance and end its trade surpluses, it would create huge problems for deficit countries, which require substantial time to shift their economic models towards balanced domestic production and consumption. Pressuring China on its currency policies is a self-defeating tactic. Instead of focusing on exchange rate policy, where progress is difficult and conflict dangerous, the international community should explore new ways to solve structural problems.

People tend to be closed-minded in some areas, but open-minded in others. Policymakers should identify areas important in solving structural problems where the majority of people are open-minded. There are many useful candidates for solving structural problems not only for China, but also for Asian economies in general. Introducing more competition in service sectors, which can be associated with liberalisation of foreign direct investment in service sectors across countries, will play a significant role in shifting resources from tradable sectors to non-tradable sectors, and therefore reduce Asian trade surpluses. Various tools, including shifting governments’ expenditure from subsidies to investment, and exports to the provision of public goods, establishment of a social safety net, increasing environmental protection, liberalisation of factor prices, and other measures could be useful in addressing structural problems.
The plight of an immature international creditor

RONALD I. MCKINNON

Going in to the G20 a headline if understated issue will be how to manage the exchange rate regime. Exchange rate flexibility is commonly seen to be at the nub of the ‘global imbalance’ problem. China is again under heavy political pressure from the US to appreciate the renminbi (Rmb) or yuan. ‘Rebalancing’ and exchange rate movements are key political questions domestically in two of the largest members of the G20; essential to any significant progress on any issue will be achieving a currency win-win.

Behind much of the political clamour is the academic view that exchange rate ‘flexibility’ is itself desirable—particularly as a way of correcting imbalances in foreign trade. Bowing to this foreign pressure, the People’s Bank of China (PBOC) announced in June that it was unhooking its two-year-old peg towards flexibility. But since then the yuan-dollar rate has moved very little, hence a sense of outrage among American and European politicians that they were deceived.

But China’s government is trapped in two important respects.

First, government officials and economists on both sides are in thrall to a false theory: that a discrete appreciation of the Rmb against the dollar would predictably reduce China’s trade surplus and US trade deficit. China’s trade surplus simply reflects its net surplus of savings, and vice versa for the saving-deficient United States: there is no presumption as to how relative savings would move if the RMB was appreciated. Moreover, China’s currently extremely high investment ratio has a long way to fall; perhaps any presumption should be that China’s trade balance (net saving surplus) would increase with RMB appreciation.

Second is the vital issue of exchange rate flexibility. It is impossible for the PBOC to simply let the ‘market’ decide what the rate should be when at the same time it has a huge surplus. Many well-meaning commentators believe market-determined exchange flexibility is warranted. US Treasury Secretary Timothy Geithner’s speeches indicate he believes so, albeit using a much more measured and careful tone than other Americans who are involved in ‘china-bashing’. His moderate and seemingly reasonable approach—let the yuan/dollar rate reflect ‘market forces’—is still not feasible.

Why?

China is in the historically unusual position of being an immature creditor. Its own currency, the renminbi, is hardly used to finance its huge surplus. Instead the world trades on a dollar standard. We have an anomaly: the world’s largest creditor cannot finance foreign investments in RMB. This lag in international RMB use is partly because China’s domestic financial markets are immature, with interest rate restrictions and foreign exchange capital controls. World financial markets also prefer one or two national currencies for clearing international payments: currently the dominant dollar and the regionally powerful euro—although the PBOC is trying hard to encourage the RMB’s use around Asia.

The upshot is that China’s own currency is little used in lending to foreigners. Foreigners won’t, and often can’t, borrow from Chinese banks or issue RMB-denominated bonds in Shanghai. China’s domestic private financial institutions cannot afford to hold the dollar-denominated trade surplus: their liabilities are in RMB and the exchange rate risk is prohibitive. China’s current account surpluses at about $200 to $300 billion per year would quickly become much greater than the combined net worth of all of China’s private financial institutions.

Accordingly the intermediation of China’s savings surplus is left to the central government, which has four major tools available:

• the accumulation of liquid reserves of foreign exchange, currently about $2.5 trillion;
• the creation of sovereign wealth funds, like the China Investment Corporation (CIC), to invest overseas;
• encouraging state-owned enterprises to invest in, or partner with, foreign companies; and
• quasi-barter aid programs in developing countries which generate a return flow of industrial materials.

China does not give ‘aid’ to African or Latin American countries in the conventional form, preferring to...
combine overseas investment with aid under fairly strict government control. In return for using state-owned construction companies to build large-scale infrastructure the recipient country agrees to give China a claim on a future resource stream. Because these foreign aid investment projects are under the control of state-owned financial intermediaries, they become effectively illiquid and cannot become part of hot-money flows back into China.

Each of these techniques for intermediating China’s saving surplus internationally keeps any gains in ‘safe’ government hands; they won’t be suddenly liquidated due to any external shock. This minimises, but does not eliminate, the possibility of hot-money inflows back into China that could destabilise the exchange rate and make monetary control more difficult.

Tiny Singapore is also an immature creditor whose own currency is not used for international lending, and whose government also tightly controls overseas financial intermediation. Singapore’s net saving (current account) surpluses have been persistently the world’s largest for many years. To prevent hot-money flows it essentially nationalises the internal flow of saving by requiring all Singaporeans to deposit into the Singapore Provident Fund, a state-run defined-contribution pension scheme. Then Provident Fund capital is lent to two giant sovereign wealth funds: the Government Overseas Investment Corporation (GIC), which invests in fairly liquid overseas assets, and Temasek, which is more of a risk-taker in foreign equities and real estate. This is the ‘Singapore solution’ to international financial intermediation by an immature creditor country, while preserving monetary control. Singapore is too small for Americans and Europeans to complain about its disproportionately large trade surplus, and demand that the Singapore dollar be appreciated. China (and Japan before it) are not so lucky.

Surplus-saving Japan is also an immature international creditor because the yen is infrequently used to denominate international claims. But, unlike China’s or Singapore’s governments, Japan’s government does not dominate the international intermediation of its savings surplus as much. Large Japanese corporations make heavy overseas direct investments in autos, steel, electronics, and so on. But, in addition, Japanese banks, insurance companies, and pension funds have become big holders of liquid assets, denominated in many foreign currencies.

This part of the Japanese system for overseas investment is vulnerable to hot-money flows. Over the last 20 years, carry trades out of low-yield yen assets have been commonplace with a weakening yen. These can suddenly reverse, as in 2008, leaving the Japanese economy vulnerable to runs from dollars to yen.

China has mitigated—although not escaped from—the immature creditor dilemma. If it tried to float the RMB then non-state Chinese banks would not accept the risk of financing the huge trade (saving) surplus by accumulating dollar claims. There would be no net buyers of the dollars thrown off by China’s large export surplus. The RMB would spiral upward indefinitely until the PBOC was dragged back in to reset the rate. Contrary to Secretary Geithner’s suggestions, there is no market solution for the exchange rate for a large immature creditor country.

This, then, is the major challenge to the G20 meeting in Seoul: ensuring global macro-stability whilst ignoring the clamour of protectionism. A rocketing RMB is not in the global interest, and for economists or diplomats to pretend otherwise is dangerous. An integrated China following Singapore’s example is far better for the international economy than a separate and defensive China vulnerable to erratic shocks.
Reform of the International Monetary Fund has been a constant theme of all G20 summits since November 2008. Although the G20 has yielded some concrete results in coordinating macroeconomic policies and financial regulatory reform, the same thing cannot yet be said about the promised IMF reform.

In view of the role the IMF must play in the post-financial crisis world, the leaders at the first G20 Summit in Washington in November 2008 expressed a commitment to advance reform so as to increase the ‘legitimacy’ and ‘effectiveness’ of the IMF and instructed the finance ministers to review its mandate and governance. At the Pittsburgh Summit in September 2009, the leaders recognised the need to reform the IMF’s governance as ‘a core element of our efforts to improve the IMF’s credibility, legitimacy, and effectiveness’, and agreed to address, among others, ‘the size and composition of the Executive Board; ways of enhancing the board’s effectiveness; and the Fund Governors’ involvement in the strategic oversight of the IMF’.

Despite the rhetoric, the G20 has not achieved results when it comes to IMF reform. To be sure, important changes have taken place at the IMF. The IMF has been able to augment its resources, including through securing bilateral loan commitments; there has been an expansion of the New Arrangements to Borrow (NAB); and agreement on a new general allocation of Special Drawing Rights (SDR). Parallel to these developments has been what Dominique Strauss-Kahn, the IMF Managing Director, has called a ‘modernisation’ of conditionality, designed to remove the ‘stigma’ attached to IMF borrowing. Although the global crisis brought some lending business back, the IMF decided to make its facilities more attractive to potential borrowers by establishing a Flexible Credit Line for pre-qualified ‘strong performing’ economies, and also by doing away with quantitative performance criteria for macroeconomic policy.

The G20 may well have helped build the consensus for such reforms more quickly, but these changes were dictated by the extraordinary nature of the global financial crisis, and the G20 cannot claim much credit. Rightly, the London Summit of April 2009 simply noted ‘the progress made by the IMF with its new Flexible Credit Line and its reformed lending and conditionality framework’.

The G20 Summits have stressed the need to increase the voice and representation of new economic powers in the governance of the IMF, but the latest agreement on quota reform had already been made before the first G20 Summit. What the G20 has called for is to accelerate the schedule of the next quota reform, stipulating that the process must be completed by January 2011, with an adjustment of at least 5 per cent toward the under-represented dynamic emerging market economies. Yet quota reform is a zero-sum game. To achieve the adjustment of an even 5 per cent is probably a political feat that would only be possible with the full might of the G20. But in substance it amounts to virtually nothing even if it is achieved as promised.

IMF governance reform will be particularly important, going forward, because the stigma attached to IMF borrowing, at least for many Asian countries, is related not to conditionality, but fundamentally to
the perception of how the institution is run. Streamlining conditionality is not the way to win back Asia’s trust. To win this trust, the IMF must be perceived to be politically neutral; Asia must feel that it has sufficient ownership in the strategic oversight of the institution. The lack of Asian influence reflects the lack of Asian intellectual input. Asia must specify what must be done to allow the IMF to become a global financial safety net for the region once again. For example, Asia could reasonably demand a quota share of 35 per cent for the region (compared with just over 20 per cent now); IMF management should be made more independent of the political process by removing the executive board from day-to-day operations, consistent with modern corporate principles.

The G20 is about to propose a transparent and merit-based process of selecting the senior leadership of the IMF. But is this all that the leaders of nations that claim over 80 per cent of world GDP can agree on after two full years of discussion? If so, the utility of the G20 process as the premier forum for international economic cooperation might rightly be questioned, once the immediate task of responding to the global crisis has been completed.

Strengthening global financial safety nets is high on the agenda of the Seoul Summit, but if strengthening global financial safety nets involves an enhanced role for IMF financing in the post-crisis world, the required reform of IMF governance must be far-reaching. Otherwise it can hardly be expected that any of the major dynamic Asian economies will utilise what the IMF may offer, even when called for by another extraordinary crisis.

WHAT ANCHOR?

Does Asia have common interests in global monetary system reforms?

SUMAN BERY

The East Asian countries responded with coherence and vigour to the weaknesses in their financial systems revealed by the crisis in 1997-98. This raises two issues. First, how important does that earlier agenda remain? Second, is it reasonable to expect comparable alignment among the Asian members of the G20, particularly on the inter-related issues of global imbalances and the reform of the international monetary system?

Among the ASEAN+3 group of countries (the ASEAN 10, Japan, Korea and China), there is a well-established narrative on the 1997-98 financial crisis. The crisis had its roots in an excessive reliance on short-term foreign debt, stimulated by fixed exchange rates and inconsistent monetary policies, intermediated through fragile and poorly supervised banks. By contrast, fiscal policies were not to be blamed. There was also extreme anger at the high-handed treatment countries received from the International Monetary Fund.

Based on this assessment, the regional policy response was two-fold. One pillar was the Asian Bond Market Initiative (ABMI), designed to deepen local currency bond markets in the major emerging markets of the region, so as to provide an alternative to bank financing. The second was the Chiang Mai Initiative (CMI). While this originally consisted of bilateral swap lines among regional central banks, it has now been expanded in scale and has also been multilateralised to provide a regional source of liquidity to complement support from the IMF.

The third element of the region’s response was the massive resort to ‘self-insurance’ through the accumulation of foreign exchange reserves in a number of countries. This has triggered fierce controversy, particularly between China and the US, on the role of this Asian ‘savings glut’ as an underlying driver of loose monetary conditions.

So what should be done now? And is it likely that the other Asian members of the G20 (India, Indonesia and Australia) will feel able to make common cause with Japan, Korea and China for a distinctive Asian view on international monetary and financial reform?

All G20 countries clearly desire a monetary order that supports orderly, non-inflationary global growth. However, of the six Asian members of the G20, only China and Japan seem likely to have chronic saving surpluses into the indefinite future. The
remaining four will have an interest in a global monetary order which remains conducive to vibrant flows of cross-border capital.

China has been most aggressive in condemning the post-Bretton Woods reserves ‘system’ (or non-system) as providing the United States an unacceptable ‘exorbitant privilege’ as reflected in the scale of its current account deficits.

While there can be legitimate criticism of the conduct of US monetary and fiscal policies over the last two decades, these have relatively little to do with the role of the US as the supplier of reserves. Indeed, one could just as well argue that China has enjoyed an equivalent privilege in its ability to become the workshop of the world while maintaining a depreciated real exchange rate. It seems to me unlikely therefore that Chinese efforts to replace the dollar will, by themselves enjoy much support.

As pointed out by Barry Eichengreen, any displacement of the dollar is likely to be a market-driven response, based on global perceptions of the quality of economic management in the US. There is also a logical fallacy at the heart of the Chinese critique. Supplying the world with dollar reserves does not oblige the US to run a deficit on its current account, merely a deficit on its basic balance.

The recent resort by Japan to currency intervention suggests that even the advanced countries are beginning to feel the burden of major swings in nominal exchange rates. Yet it is difficult to believe that the genie of mobile capital will easily be put back in the bottle. One should not forget that, for all its imperfections, it is under the post-Bretton Woods non-system that Asia has prospered.

It is unlikely that there will be a common ‘Asian’ view on international monetary reform at the G20. China apart, most of the other members remain at ease with a US anchored monetary system, with the comfort of alternatives, initially the euro, and in due course the renminbi. What is desirable is to strengthen the safety net available to emerging markets so they feel less need to accumulate reserves. This initiative, being pushed by Korea, probably represents the limits of what is feasible, and perhaps even what is desirable. And as for the earlier Asia-specific reform agenda, it is no longer where the action is likely to be.

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