G20
SEOUL SUMMIT 2010

Korea-Canada-France
G20 Seminar

17-18 September 2010, Lotte Hotel Seoul, Republic of Korea

GSIS
The Graduate School
of International Studies
Seoul National University

NPSIA
The Norman Paterson School
of International Affairs
Carleton University

SciencesPo.
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Korea-Canada-France G20 Seminar

17-18 September, 2010

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Program

Korea - Canada - France G20 Seminar

Friday, September 17, 2010

18:30 **Reception and Welcoming Dinner** hosted by Financial Services Commission (Belle-vue Suite, 36th Floor)
Welcoming Remarks
Mr. Dong-Soo Chin (Chairman of Financial Services Commission, Korea)

Saturday, September 18, 2010

(Emerald Room, 2nd Floor)

09:00-09:30 **Introduction and Welcome**

(Co-Chairs)
Prof. Yung Chul Park (Distinguished professor and former Senior Economic Advisor to the President of the Republic of Korea, Korea)
Mr. Derek H. Burney (Former Canadian G7 Sherpa, Former Canadian Ambassador to the United States, Canada)
Dr. Jean Pisani-Ferry (Director, Bruegel, Prof., Université Paris-Dauphine, France)

09:30-10:50 **Session 1: Global Economy and Framework**

- What is the global economic outlook toward the Seoul Summit?
- What should be the top policy priority for the G20 framework exercise toward the Seoul Summit? (e.g. rebalancing, fiscal consolidation or the structural reform)
- Where can we find new sources of global growth, given that most countries don't have much room to maneuver, especially in the fiscal side?
- How do we communicate with the market when we deliver the outcomes in November?
- How do we develop the framework process after the Seoul Summit?

Moderator
- **Dr. Soogil Young** (Chairman of the Presidential Committee on Green Growth, Former Korean Ambassador to OECD, Korea)

Presenters
- **Dr. Dongchul Cho** (Professor of Korea Development Institute school of Public Policy and Management, Korea)
- **Dr. Wendy Dobson** (Professor and Co-Director, Institute for International Business, Rotman School of Management, University of Toronto, Canada)

Discussant
- **Dr. Denis Beau** (Directeur General Adjoint, Banque de France, France)

10:50-11:10 **Coffee Break**

11:10 -12:30 **Session 2: Reform on International Financial Institutions and the International Monetary System**

- What progress has been made in the IFIs reform since the Pittsburgh summit?
- What would be the appropriate size of quota increase for the IMF to continue to fulfill its expanded role in the global economy? How can we best realign the quota shares to reflect the relative weights of the IMF members in the world economy?
- What specific policy initiatives does the G20 need to pursue in order to ensure broader governance reforms regarding the size and composition of the Executive Board, management selection process, ministerial involvement, and staff diversity?
- What are the impediments to conclude IMF reform by the November Seoul Summit as agreed in Toronto on June 2010, and how we can overcome them?

Moderator
- **Dr. Jean Pisani-Ferry** (Director, Bruegel, Prof., Université Paris-Dauphine, France)

Presenters
- **Dr. Sungmin Kim** (Director General, G20 Affairs Office, Bank of Korea, Korea)
- **Dr. Philippe Martin** (Prof., Chairman of the Department of Economics, Sciences Po, France)

Discussant
- **Mr. Thomas d' Aquino** (Former CEO of the Canadian Council of Chief Executives, Canada)

P R O G R A M

12:30-13:30	**Lunch** hosted by Bank of Korea (Garnet Suite, 37th Floor) **Luncheon Speech** **Dr. Jae Chun Kim** (Deputy Governor of the Bank of Korea, Korea)

13:30-15:00 **Session 3: Development**

- How should development multi-year action plans be carried from the Seoul Summit to the France Summit and beyond?
- How can the G20 development approach be effectively differentiated from that of the G8?

Moderator
- **Dr. Yoon Je Cho** (Professor of Sogang Graduate School of International Studies, Former Economic Advisor to the President of the Republic of Korea, Korea)

Presenters
- **Mr. Antoine Chery** (Special Representative of the Treasury for the French 2011 G20 Presidency, France)
- **Dr. Wonhyuk Lim** (Director of Policy Research Center for International Development, Korea Development Institute, Korea)

Discussant
- **Mr. Peter Harder** (Former Deputy Minister of Foreign Affairs, Chair of the Canada-China Business Council, Canada)

15:00-15:20 **Coffee Break**

15:20-16:50 **Session 4: Reform on Financial Regulation and Financial Supervision**

- What progress has been made in bank capital rules since the Toronto Summit?
- What specific policy initiatives does the G20 need to pursue in order to regulate SIFIs?
- What would be the appropriate measures for internationally consistent implementation of various reform initiatives?

Moderator
- **Hon. Barbara McDougall** (Chairman of International Development Research Centre, Former Foreign Minister of Canada, Canada)

Presenters
- **Mr. Nicolas Veron** (Senior Fellow, Bruegel, France)
- **Mr. Gorden Thiessen** (Former Governor of the Bank of Canada, Canada)

Discussant
- **Mr. Jong Goo Yi** (Standing Commissioner, Financial Services Commission, Korea)

16:50-18:20 **Session 5: International Trade**

- While the global economy is recovering, the risk of resorting to protectionist measures will remain as long as unemployment levels are high. Is there any additional contribution the G20 can make for resisting protectionism?
- What can be considered as possible options for Leaders at the Seoul Summit to discuss the way forward, with a view to seek conclusion of the DDA negotiations?
- What can the G20 contribute to maintaining the momentum of aid for trade and trade facilitation?
- Keeping markets open plays a critical role in creating jobs and economic growth. Which elements should be addressed to analyze the relation trade has to employment and growth? What are considerable policy implications?

Moderator
- **Dr. Taeho Bark** (Dean, Graduate School of International Studies, Seoul National University, Korea)

Presenters
- **Dr. Wook Chae** (President, Korea Institute for International Economic Policy, Korea)
- **Mr. John Weekes** (Former Canadian Ambassador to the WTO, Canada)

Discussant
- **Dr. Patrick Messerlin** (Prof., Director of Groupe d'Economie Mondiale, Sciences Po, France)

18:20-18:40 **Closing**

- Concluding Remarks by Co-Chairs
- Closing Remarks by Conveners

19:30 **Reception** hosted by Embassy of France to Korea (The residence of **H.E. Elisabeth Laurin,** Ambassdor of France in Korea)

Special Guests

Korea

- **Mr. Ho-young Ahn,** Deputy Minister for Trade, Ministry of Foreign Affairs and Trade and G20 at large Ambassador
- **Prof. Byung-il Choi,** Dean of Graduate School of International Studies, Ewha Womans University
- **Mr. Oh-seok Hyun,** President, Korea Development Institute
- **Prof. In June Kim,** Department of Economics, Seoul National University
- **Prof. Sang-kee Min,** Business School, Seoul National University
- **Prof. Yeongseop Rhee,** Graduate School of International Studies, Seoul National University
- **Mr. Bong-Kil Shin,** Ambassador for International Economic Cooperation, Ministry of Foreign Affairs and Trade
- **Mr. Je-yoon Shin,** Deputy Minister for International Affairs, Ministry of Strategy and Finance

France

- **H.E. Elisabeth Laurin,** Ambassador of France in Korea

Canada

- **H.E. Edward Lipman,** Ambassador of Canada in Korea

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Paper

Global Economy and Framework

September 18, 2010
Dongchul Cho

1. Global Crisis and the G-20

The recent crisis that broke out in September 2008 sparked bold policy reactions in the global community. In many countries, interest rates were lowered to near-zero and fiscal deficits were greatly expanded. Many emergency measures to rescue financial markets were also taken simultaneously. History will record the past 2 years as the period of the most active policy coordination across countries, and place the G-20 summit meeting at the heart of this critical event.

Thanks to these policy efforts, the global economy turned around from the second half of last year. This was truly a big achievement, considering the panic of the market in 2008 when analysts and commentators pushed out extremely gloomy forecasts and referred to the trauma of the Great Depression. After two years, however, Michael Bordo (2010) concluded “the economic impact of the Great Depression dwarfed that of the recent crisis,” based on his study on crisis experiences since 1880.

This success was not achieved without cost; it was accompanied with huge costs, particularly in fiscal soundness. Budget deficits in 2009~2010 were expanded to obviously unsustainable levels in many countries, resulting in explosive increases of public debts to the levels that the market began to concern. In fact, the ‘unprecedented’ impact of the recent global crisis was not manifested on GDP or employment but on public debts. Further stimulation by fiscal policy, at least in some countries, could rather destabilize the global financial market, as was evidenced by the case for some South European countries in the first half of this year. Faced with this development, the G20 summits at the Toronto meeting in June announced, “Advanced economies have committed to fiscal plans that will at least halve the deficits by 2013 and stabilize or reduce the government debt-to-GDP ratios by 2016.”

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This stance of the G-20 for fiscal consolidation has been challenged whenever downside risks emerged and financial markets jittered. As long as macro-policies are based on uncertain forecasts about the future, it is impossible to design an unarguable policy stance, *ex ante*. Nevertheless, identifying and checking relevant issues are always proven fruitful in minimizing the probability that we end up with regrets about policy mistakes, *ex post*.

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2. Global Economic Prospect and Assessment

In order to properly discuss macro-policies at the G-20, the following issues regarding economic prospect need to be examined:

(i) Is 'double-dip' a likely scenario?

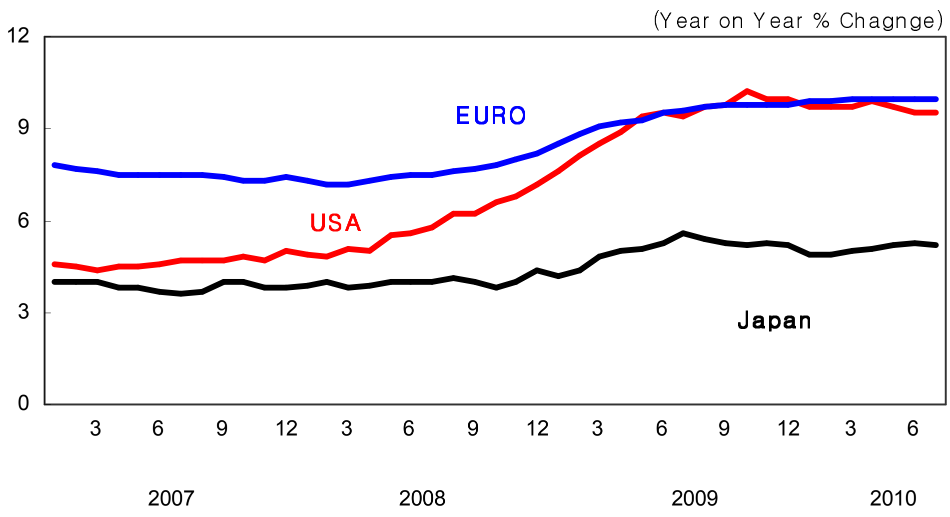
(ii) Is the recovery to the pre-crisis level an appropriate reference?

(iii) Is there a risk that growth slowdown is structural rather than cyclical?

(i) <u>'Double-dip'?</u>

Despite economic recovery, unemployment rates remain high and non-performing loans have not been significantly reduced in many advanced countries (Figure 1). Against this backdrop, if fiscal stimulus is rapidly withdrawn, it may hamper overall recovery momentum --- according to the double-dip scenario.

Figure 1: Unemployment Rates

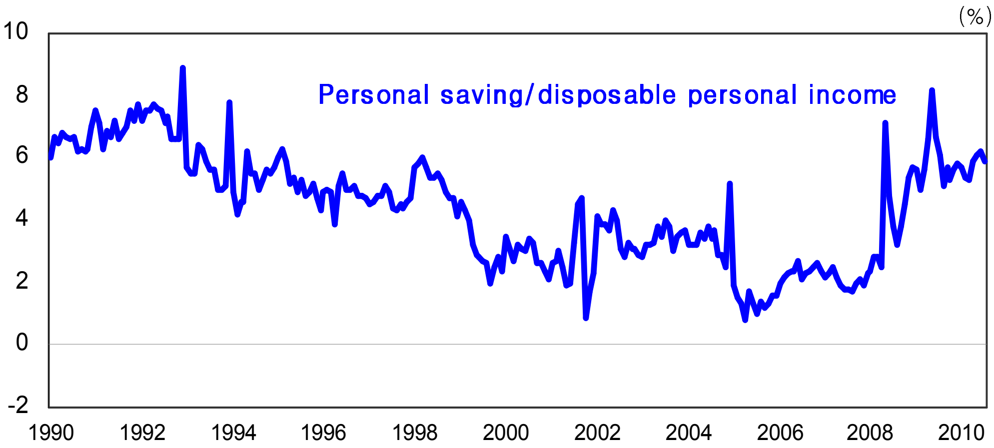


Source: Eurostat(Euro), Census Bureau(USA), Statistics Bureau(Japan).

This is a risk scenario, however. The base-case scenario in most forecasts including the IMF's and OECD's is a slow but steady recovery over the years to come (at 4~5% of annual growth for the world and 2~3% for advanced countries). Private sector's recovery momentum is being accumulated and fiscal consolidation is projected to be carried out gradually. The fiscal consolidation plan recommended by the G-20 also provided a reasonable degree of short-term leeway for gradualism. While a plan B needs to be prepared for a risk scenario, the plan A should be based on the base-case scenario of the consensus forecast.

A related issue is how deep it would be and what would be its main cause, if a double-dip scenario were realized. Since the Lehman Brothers bankruptcy filing, major risk factors in the private sector have been revealed and adjusted to an extent. In particular, the potential risks associated with asset market bubbles have been reduced to the extent that asset prices have been corrected. The US consumers' saving rate, which had long been pointed as a warning signal, also restored its pre-bubble period level (Figure 2). Even for a pessimistic scenario, it seems unlikely that such a panic as the one in September 2008 will resurge.

Figure 2: US Personal Saving Ratio



Source: U.S. Department of Commerce, Bureau of Economic Analysis.

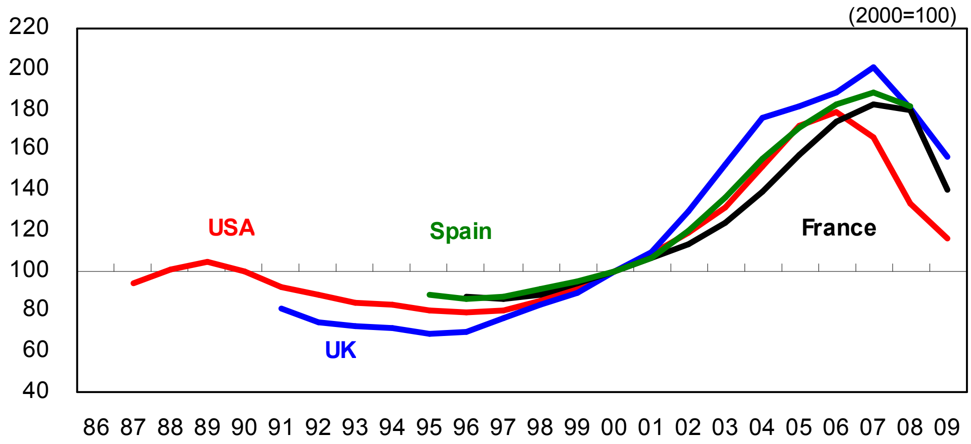
While the risks of the private sector have been reduced, those associated with public debts have been substantially increased. Although it seems impossible to pin down the threshold level of public debt, it is clear that the financial market is increasingly concerned about public debt problems of advanced countries, and that it would be disastrous if the panic were ever triggered. Of course, this is a very unlikely scenario for the near future, but it is important to bear in mind that the risks are being transmitted from private to public sectors.

(ii) Recovery to the Pre-crisis Levels?

Another issue to be considered is how to assess the current economic states. It is widely agreed that demand conditions of major advanced countries are still weak, thereby requiring continued policy stimulus, but the perceptions about magnitudes appear to differ.

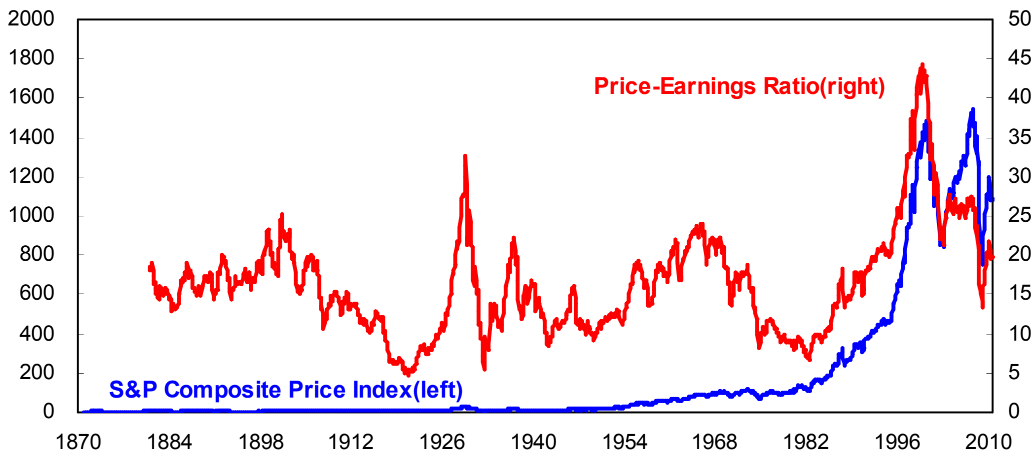
Theoretically, it would be ideal to estimate the gaps between the current and potential levels of GDP (or the current and natural rates of unemployment) in order to gauge the required policy stimulus. While such estimates are always controversial in practice, the idea itself provides an insight that the pre-crisis economic states may not be the desirable targets that we wish our economies to recover to in the near future. For example, the unemployment rate below 5% in conjunction with around 4% of economic growth in the U.S. before the crisis was regarded as signals of unsustainable overheating for several years. The U.S. stock price index has not recovered to the pre-crisis level, but the current level does not appear to be particularly low compared to its long-run trend (Figure 3). While housing markets are still weak in many advanced countries, house prices in real terms are still higher than historical average levels (Figure 4). The current recovery pace can be perceived to be “painfully slow” as the US president, Obama, described it. However, a substantial portion of this pain may be attributable to the excessive enjoyment before the crisis.

Figure 3: Real House Prices



Source: Banco de Espana(Spain), INSEE (France), Nationwide (UK), S&P/Case-Shiller Home Price Indices (USA).

Figure 4: US Stock Price and Price-Earnings Ratio



Source: http://www.econ.yale.edu/~shiller/data.htm.

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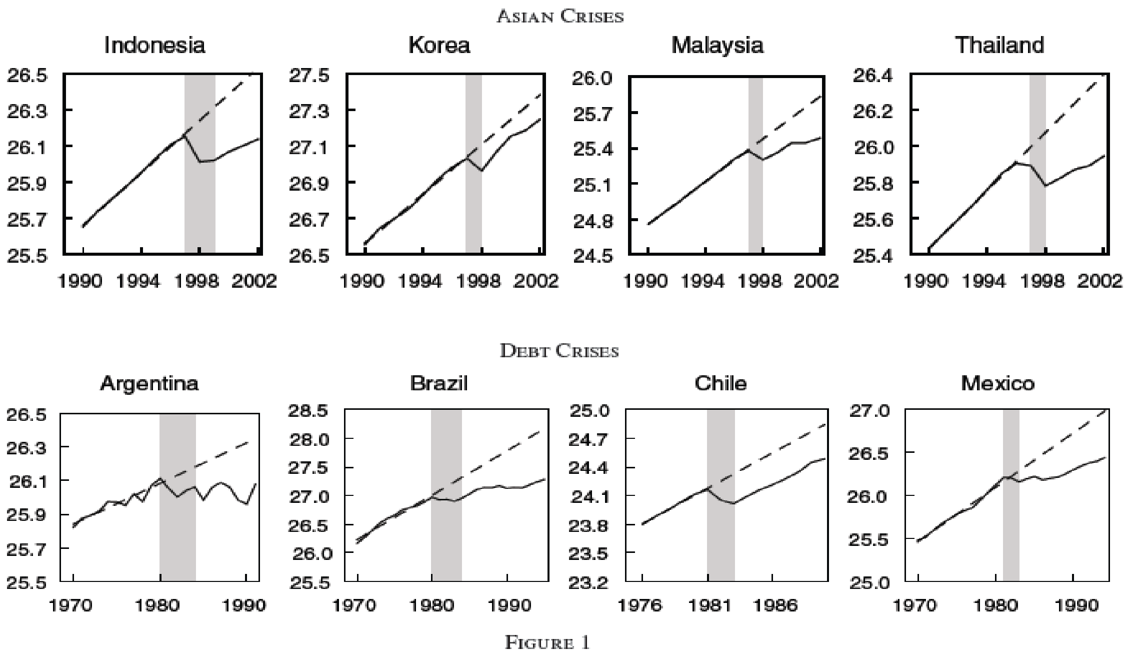
(iii) Structural vs. Cyclical?

Furthermore, there is uncertainty about whether the current economic difficulties are entirely attributable to cyclical factors. Many research results (Figure 5 from Cerra and Saxna (2008), among others) show that crisis-hit countries could not completely restore their pre-crisis paths of GDP as well as pre-crisis levels of unemployment rates even after 10 years from the crises, which strongly suggests that a substantial portion of the loss in GDP and/or employment due to the recent financial crisis may be permanent (or structural) rather than temporary (or cyclical).

Figure 5: Crisis and GDP



If this is the case for advanced countries, then the risk to the global economy is not just a short-term double-dip but a structurally sluggish recovery for several years. In this case, continued expansionary policy cannot be the solution: it should be dealt with by structural policies.

3. Fiscal vs. Monetary Policy

Although the base-case scenario for the global economy is a gradual recovery, it is necessary to prepare for a downside risk. The next question is then which one among fiscal and monetary policy measures would be better to cope with risk scenarios. For this question to be properly answered, the following issues need to be considered:

(i) Which policy is more flexible?
(ii) Which policy is more sustainable?
(iii) Are there rooms for further monetary stimulation?

(i) Flexibility

It is largely agreed that monetary policy can be more flexibly adjusted than fiscal policy that should go through complicated political processes. In addition, spill-over effects on other countries' demand are more pronounced for fiscal policy than for monetary policy, whose effects can be neutralized by a resulting currency value adjustment (if the exchange rate is floated). Therefore, the more uncertain and country-specific the risks are, it would be more efficient, in general, for monetary than fiscal policy to react to unexpected high-frequency shocks.

Of course, if a shock is expected to generate a devastating outcome for a prolonged period of time (such as the shock we experienced in the fourth quarter of 2008), it would be justifiable to re-engineer the projected trajectory of fiscal policy. Particularly, if the shock paralyzes the financial market as in 2008 so that monetary policy alone cannot cope with the problem, more active pump-priming efforts from the fiscal body would be necessary. In this regard, not only the existence of downside risks but also the expected intensity of the risk scenarios needs to be discussed. At the moment, however, the probability that such a major shock is realized seems slim.

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(ii) Sustainability

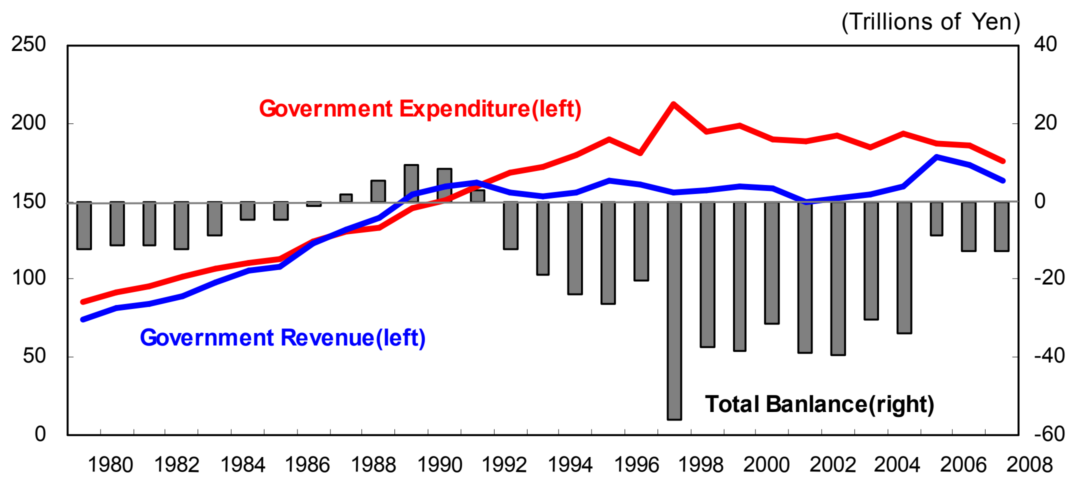
Another dimension to be considered is the sustainability of expansionary policies. As far as fiscal stimulation is defined as an increase of fiscal deficit (in percent of GDP) from the previous period, it cannot be extended indefinitely almost by definition. For many advanced countries, even maintaining the current levels of fiscal deficit (in percent of GDP) do not seem to be sustainable, considering their implications on public debt-to-GDP ratios. Although the tolerance level of public debt remains unclear both theoretically and empirically, the recent finding of Reinhart and Rogoff (2010) for advanced countries is suggestive: “median growth rates for countries with public debt over roughly 90 percent of GDP are about one percent lower than otherwise” (p.573). The implication of this finding is that it is extremely unlikely for debt-ridden countries to simply ‘grow’ their way out of the problem without fiscal consolidation. Currently, public debt-to-GDP ratios are already over 90 percent for some advanced countries, and are projected to reach this level within the years to come for many other countries.

In contrast, monetary expansion has no physical limit: central banks can print money indefinitely. The market cannot cast doubt about its sustainability *per se*. The associated risk of excessive money supply is the loss of paper money’s attractiveness, namely inflation of prices for either goods and services or assets. But this is something that policy-makers are aiming for under the current economic situation with deflation risks. Compared to the risks associated with public debt overhang, the inflation risk is relatively easy to detect and likely to be short-lived as far as inflation targeting is credibly committed.

Furthermore, if it is unclear whether the downside risk is structural or cyclical, monetary stimulation can be less dangerous than fiscal expansion in the long run. When potential growth rates are lowered, the natural (or ‘neutral’) interest rates are also lowered, thereby reducing the risks associated with low interest rate policies. In contrast, if fiscal stimulation is continued in response to structural slowdown, it will only worsen the public debt problem to the extent of reduced fiscal revenues due to slow growth in the long-run.

The Japan’s case is illustrative. In response to the recession in the early 1990s, fiscal spending was increased and interest rates were lowered (with hesitation). Since then, these policy stances, notwithstanding some short-term variations, have been largely maintained, while it remained unclear whether the sluggish performances stemmed from structural or cyclical factors. After 20 years, the Japanese government inherited huge debts of almost 200 percent of GDP, which was increased from approximately 50 percent in 1990. This explosive increase in public debts was not because the fiscal stimulation was ineffective in boosting the economy in the short-run (see Kuttner and Posen (2002)). It was simply because fiscal policy could not enhance long-term sustainable growth inherently and monetary policy failed to generate a reasonable rate of inflation, both of which were crucial in reducing the growth rate of fiscal revenue (Figure 6). In contrast, the damage caused by 'excessively' low interest rate policy appears to be non-existent. A lesson to learn from the Japan's monetary policy experiences would be that it needs to be sufficiently aggressive with respect to deflation risks that would be harmful not only for economic vitality but also for fiscal consolidation.

Figure 6: Japan's Fiscal Revenue, Expenditure, and Balance



Source: OECD (2010).

(iii) Feasibility of Additional Monetary Stimulation

As for monetary policy, the current concern is not its flexibility in a conventional context, but its capability to further stimulate the economy under the circumstances of near-zero target interest rates. That is, the question is whether central banks still reserve effective tools for defending the economies from possible deflationary shocks.

To this question, US Federal Reserve Chairman, Bernanke (2010), recently listed three options that the FED reserves, (1) conducting additional purchases of longer-term securities, (2) modifying the Committee's communication, and (3) reducing the interest on excess reserves, and discussed the pros and cons of each option, respectively, in his address at the Jackson Hole. These options are not completely new now, but they (particularly the first option) proved to be effective in weathering the financial market turmoil of the 4th quarter 2008. Additional and more drastic options for monetary easing can also be innovated, if the economic situation deteriorates further. For example, central banks can lower the interest rate below zero for their short-term loans to commercial banks (*i.e.*, providing subsidies for commercial banks' short-term borrowings from central banks) to encourage more aggressive investment of commercial banks.

It is not clear whether the recent economic indicators require these unorthodox policy options to be exercised. In most countries, inflation rates are getting out of last year's severe deflationary pressures and economic recoveries are progressing (Figure 7). Yet, the very recent developments differ across countries, indicating that country-specific than common forces are becoming more important, which requires more active role of monetary than fiscal policy. In any case, it is extremely important to keep convincing the market that central banks are fully committed to price stability and that they do have effective tools as well as strong wills to defend their economies from any possible deflationary shocks.

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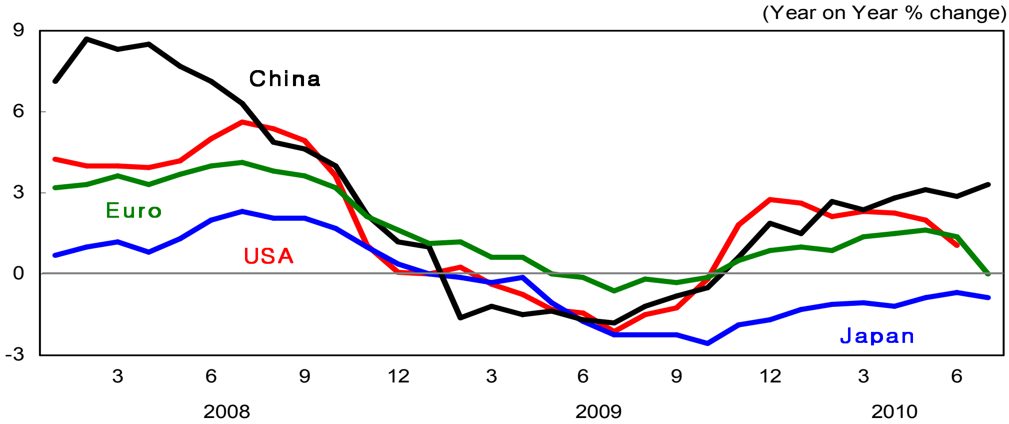
Figure 7: Inflation Rates



Source: Eurostat(Euro), Census Bureau(USA), Statistics Bureau(Japan), National Bureau of Statistics of China.

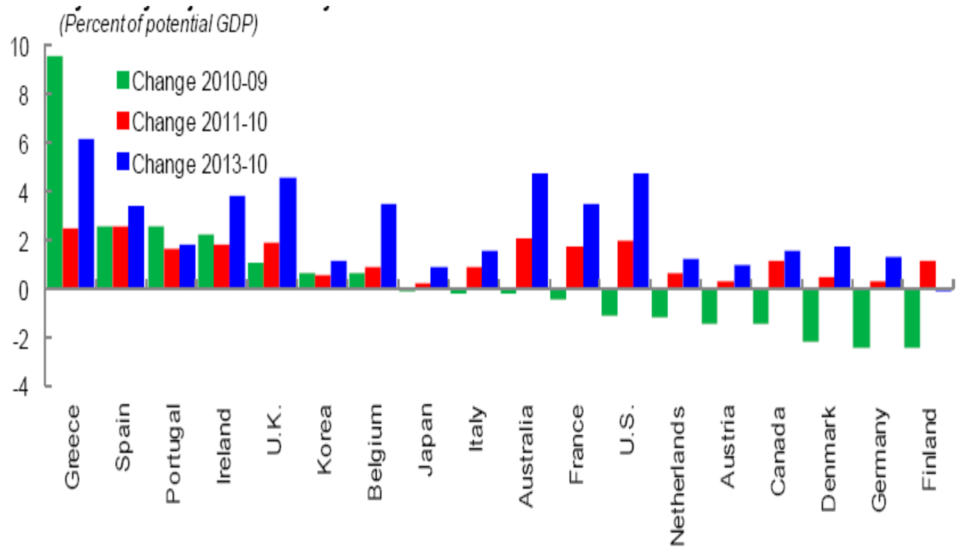
4. Summary and Recommendations

The global recovery is an ongoing process. Although its pace is bumpy and expected to moderate in the second half of 2010, the base-case scenario is still a steady recovery over the years to come, based on which the G-20 needs to design the main policy recommendations.

Yet, it is also necessary to prepare for risk scenarios. Under the current circumstances, the market will want to hear about how the G-20 perceives downside risks and what the contingency plans are. For this purpose, risk factors should be identified from various perspectives, such as (i) how likely the risk scenario is to be triggered, (ii) how severe the impacts would be, and (iii) whether the risk factors are structural or cyclical. This article argues that, under many uncertainties about the nature of risks, it would be more productive and less dangerous to have monetary than fiscal policy to flexibly respond to possible disturbances.

This background discussion leads to the recommendation that the Toronto G-20's basic stance on fiscal consolidation be carried over to the Seoul Meeting. Unless another round of global disruption is triggered, a major revision in the fiscal plan in 5 months would only damage the credibility of the G-20. As announced, each member country should submit its "growth friendly" fiscal consolidation plan, and the G-20 needs to perform the mutual assessment process. In this process, however, the G-20 can allow member country to have a limited degree of flexibility, such as the paces of fiscal adjustment to the goal in 2013 being tailored to each member country's different economic situations (Figure 8). At the same time, the G-20 can call for strong commitments of central banks to price stability so that any deflationary shocks would be actively coped with.

Figure 7: Projected Changes in Cyclically Adjusted Primary Balances



Source: IMF (2010)

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The Global Economy and Framework: Seoul's challenges

September 18 2010

Wendy Dobson

At Toronto as growth rebounded, G20 leaders agreed to a macroeconomic exit strategy, pledging to cut fiscal deficits in half by 2013 and to stabilize or reduce debt-to-GDP ratios by 2016. The G20 Mutual Assessment Process supported by the international institutions examined the global consequences of countries' domestic policies and identified opportunities for government to do things differently – and to do different things -- to contribute to more positive global outcomes.

Toronto was the easy part. At the Seoul summit Asia will be in the spotlight as the popular focus on the G20 shifts to its core task: changing the composition of demand to ensure growth is sustainable in the long term. Robust growth has resumed in the Asian economies but its composition needs to shift from reliance on external demand to greater reliance on domestic demand. The shift depends on an agenda of challenging policy changes: structural and institutional changes to encourage domestic demand, financial regulatory reforms and the successful conclusion of the global trade talks to restore market confidence.

The growth outlook

Global growth increased in 2010 to an average of 4.6 percent, but it is multi-speed (Figure 1). By IMF estimates China and India are leading the world at 9-10 percent growth rates, followed by the United States which rebounded to 31/4 percent, Japan to 2 ½ percent with the euro area lagging at 1 percent. These rates are expected to moderate in 2011 to 4.3 percent, but there have been surprises after mid-year as US growth weakened while Germany surprised with a 2.2 percent growth spurt.

Figure 1: Real GDP Growth Projections (IMF, July 2010)

What should be the top policy priority for the G20 Framework exercise?

The Toronto summit formalized medium fiscal consolidation strategies, the G20's immediate challenge. The Seoul summit should shift to deliverables on the medium-term imperative of more balanced global growth. In this section I first review progress on fiscal consolidation and then move

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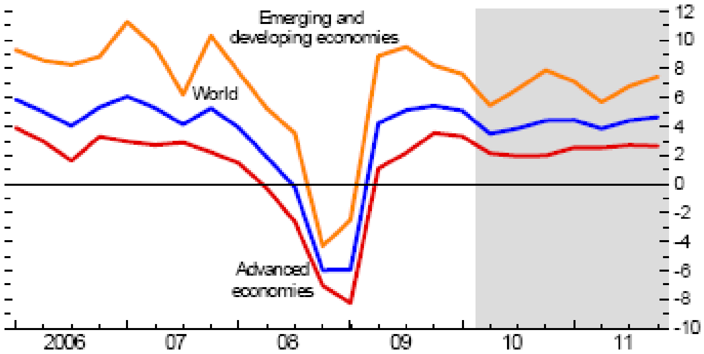
to rebalancing and structural changes in subsequent sections. 2



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Fiscal Consolidation Strategies in the Advanced Deficit Countries

In the next couple of years governments and central banks need evidence of organic growth: businesses restocking inventories; hiring rather than firing; labor market expansion that supports household income growth and consumer spending which in turn encourages businesses to invest. The evidence is still muted and so the authorities are being cautious. If stimulus is withdrawn before organic growth is re-established these economies could enter a renewed slump, even a deflationary spiral. Exit too late and precious resources are wasted and the seeds of future inflation sown. At the same time many of the large countries have little room left for further fiscal stimulus because of structural deficits and high levels of indebtedness: the IMF projects aggregate public indebtedness will be 110 percent of GDP in 2015 compared to 30 percent in emerging and developing economies.

In countries with large credit bubbles interest rates are at historic lows and central bank balance sheets are in uncharted territory. While monetary policy should not be used to reduce the real burden of public indebtedness central banks continue to rely on quantitative easing to provide stimulus.

G20 leaders' commitment to fiscal consolidation at Toronto helped to formalize exit strategies which need to be signaled well in advance to condition expectations. As the international institutions stressed in their advice to governments, these exit strategies should anticipate longer-term requirements and be 'growth-friendly'. They should take account of longer-term imperatives such as demographic shifts; thus as fiscal stimulus is removed primary balances should be improved to meet the challenges of aging populations (which implies both tax reforms and changes to entitlement spending). Governments should also shift public spending in the direction of investments that foster future growth, such as education, green infrastructure, physical infrastructure upgrading and reducing distortionary taxes. In surplus countries, shifts in spending are desirable to support households bearing the burdens of adjustments in product and labor markets in some cases and to support aging populations in others.

The exit strategies of the United States, China and Japan are of particular importance at Seoul. In the United States stimulus vs austerity is the subject of intense debate. Those arguing for more public spending emphasize that demand must be maintained by the public sector as long as private sector demand remains weak; they point to the relatively jobless recovery, rising structural unemployment (Table 1) and fiscal problems of state governments. The alternative argument emphasize that the deleveraging following a financial crisis takes a long time; that unemployment is increasingly structural unemployment because, for example, labor mobility has been reduced by the implosion of housing prices faced by those who might move. Thus reliance on more public spending will only increase public indebtedness, increase uncertainty about future taxes and inhibit businesses' investment and hiring decisions. Without a compromise, the United States lacks a credible medium-term fiscal consolidation plan. Prior to the Toronto summit President Obama publicly committed to reduce the fiscal deficit to 3 percent of GDP by 2015. But the administration's own 2011 Budget projected the deficit-to-GDP ratio will drop to 11 percent in 2010 (down from 13 percent in 2009) and decline to not more than 4 percent between 2015 and 2020 (whereas 2-3 percent is considered to be sustainable). Private sector assumptions show the deficit remaining above 5 percent of GDP in the next decade. These numbers are not sustainable.

The Administration's proposals in the 2011 budget rely mostly on expenditure compression rather than on added revenues. The imminent expiry of Bush-era tax cuts, a major factor contributing to persistent deficits, is also the subject of debate. By one argument allowing them to expire will amount to a badly-timed tax increase. The counter-argument favors expiry as a way to reduce the deficit and to raise taxes on higher-income groups. A short-term extension is a possible compromise. The economic reality is that achieving a sustainable fiscal position will require higher revenues raised in a 'growth-friendly' way, such as through tax reforms that shift the burden of taxes away from income and property towards consumption. Since no politician is willing in the current polarized political environment to advocate 3 higher taxes, the bipartisan National Commission for Fiscal Responsibility, with all expenditure and revenue items on the table, is the most promising mechanism to provide objective analysis and expert advice.

Table 1: Unemployment rates, selected economies (OECD Harmonised Unemployment Rates,

July 10 2010) Unemployment rate, 2010 Q1 (% of labor force)		**Changes in rates over the same period of the previous year** (2010 Q1 over 2009 Q1)
Euro Area	9.9	1.1
United States	9.7	1.5
Japan	4.9	0.4
Australia	5.3	0
South Korea	4.3	0.8
Mexico	5.3	0.4

China also carried out a strong fiscal stimulus program beginning in 2008. A surge in directed lending by the banking system magnified the impact of increased government spending. In 2009 China's growth performance led the world; as signs of inflation appeared in late 2009 administrative measures were used to rein in bank lending to the property markets and local governments. By mid-2010 signs of slowing activity prompted some loosening of credit for infrastructure and alternative energy investment. Exchange rate management was also eased prior to the Toronto summit as the central bank abandoned the de facto peg to the US dollar and returned to the practice begun in July 2005 of managing the exchange rate in reference to a basket of currencies.

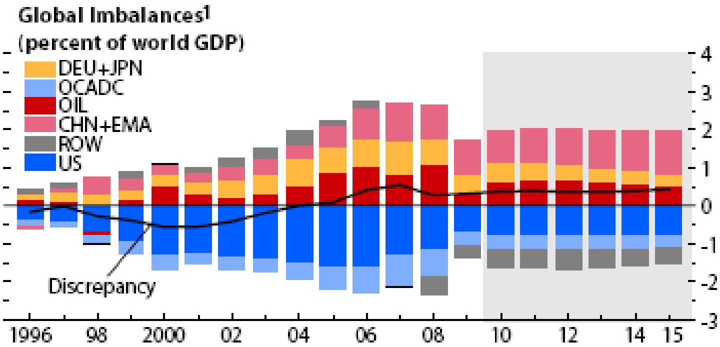
Japan, the economy most affected by the collapse of net exports in 2009, experienced a robust rebound in 2010 with growth nearly 5 percent in the first quarter and expected to average 2.4 percent for the year. As the restoration of external demand fades and fiscal policies are tightened, however, growth is expected to slow in 2011 to less than 1 percent.

While short-term macroeconomic exit and fiscal consolidation is not a particular priority in East Asian countries with prudent fiscal and monetary policies, the medium-term imperative of global rebalancing will depend their active participation in reducing reliance on export-led growth and depending more on domestic demand.

Addressing Global Imbalances

The Seoul summit must demonstrate that G20 leaders are serious about changing the composition of aggregate demand as growth returns. Global current account imbalances peaked in 2006 but the IMF expects them to rise again, as surpluses rise in East Asia with the restoration of global trade and financing 4 flows (top segment of each bar in Figure 2). To prevent their recurrence, countries with external surpluses should rely more on domestic demand and imports while those with external deficits should rely more on exports. Flexible exchange rates would help cushion the necessary adjustments.

Figure 2. Global Imbalances (IMF, April 2010)



Rebalancing will be both a technical challenge and the G20's biggest political challenge. Surplus countries in Asia resist flexible exchange rates and continue to build their foreign exchange reserves (to two segments in each bar in Figure 3). One of the lessons to draw from the disruptive market adjustments as imbalances declined in 2009 is that the process could have been smoother with flexible exchange rates. In the absence of flexible exchange rates more of the burden of adjustment must be borne by structural policies that may not be popular at home as they impact consumer and trade interests vested in the unsustainable status quo. Yet with the US consumer no longer the engine of growth a determined effort to rebalance is essential to take up the slack.

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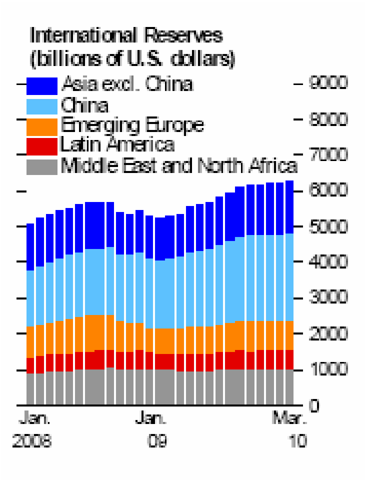
Figure 3. International Reserves (IMF WEO Update July 2010)



The IMF in cooperation with the OECD and other international organizations has shown the benefits of collective action to reduce imbalances and the risks of continuing the status quo.

In preparation for the Toronto summit the IMF prepared a base line scenario of growth and output in 2014 based on countries' own forecasts and adjustment packages. These were then adjusted for consistency and subjected to alternative assumptions reflecting upside possibilities and downside risks. Significantly the model assumes exchange rate flexibility. The differences in outcomes under the two scenarios are 5 startling. Collective action yields large benefits: world output would be higher by US$ 1.6 trillion and global growth over the next five years would be 2 1/2 percent higher than the baseline. Over 13 million jobs would be created in emerging Asia (Table 2A.)

Table 2A: Upside Scenario: Employment and Output Gains by region (IMF Mutual Assessment, June 2010)

	Employment	Unemployment 1/	Real GDP	
	(Millions)	(Percentage points)	(2009 USD billion)	(Percent)
United States	3.1	-2.0	426	3.0
Euro area 2/	4.6	-2.8	563	4.5
of which Germany	1.6	-3.8	174	5.2
Japan	0.5	-0.8	126	2.5
Emerging Asia	13.2	-0.7	128	1.4
Rest of the world	8.2	-1.1	370	2.1
World	29.5	-1.4	1614	2.5

Table 2B: Downside Scenario: Employment and Output Losses

	Employment	Unemployment 1/	Real GDP	
	(Millions)	(Percentage points)	(2009 USD billion)	(Percent)
United States	1.6	1.0	765	5.4
Euro area 2/	2.1	1.3	705	5.6
of which Germany	0.7	1.6	192	5.7
Japan	1.0	1.5	244	4.8
Emerging Asia	11.3	0.6	109	1.2
Rest of the world	6.6	0.9	301	1.7
World	22.7	0.9	2124	3.1

Notes: 1/ Unemployment for emerging Asia and rest of the world is calculated using the respective output responses and assuming the maximum estimated unemployment response in the other regions. 2/ Based on PPP-weighted average of Germany and the other euro members; employment and real GDP level is a sum of Germany and the other euro area members.

Risks in the downside scenario compared to the baseline (Table 2B) imply large losses in output and employment – 23 million jobs lost of which more than 11 million are in emerging Asia and a million in Japan —and an estimated 60 million people fall into poverty. World output will be 3.1 percent lower and unemployment nearly 1 percent higher than the baseline.

Comparison of the downside and upside scenarios provides a dramatic estimate of the global benefits of collective action. Global output would be 5.6 percentage points *higher* with policy actions (comparing Tables 2A and 2B fourth columns, bottom lines) than if the risks were to materialize. Unemployment would decline rather than rise (even in emerging Asia unemployment rises in the downside scenario).

New Sources of Growth

Key policy choices account for the difference in growth outcomes. Clearly growth-friendly fiscal consolidation in deficit countries is essential. Beyond that two kinds of structural reforms are included in the models: structural reforms that strengthen domestic demand (and replace the US consumer) and structural reforms to enhance productive potential.

Strengthening domestic demand: Countries with external surpluses are assumed to take up some of the slack in global demand by strengthening domestic demand with such measures as strengthened social safety nets with pension and health insurance programs, enhanced physical infrastructure that reduces supply bottlenecks, reformed corporate governance and more-developed financial markets that can extend credit to small and medium-sized enterprises. Household demand is assumed to expand as wage rises are permitted, restrictions loosened on labor mobility and households provided with capital income-generating opportunities. Of course the structure and timing of such reforms will depend on each country's economic circumstances and institutions.

In emerging Asia the Mutual Assessment exercise found that raising public investment in emerging Asia by 2 percent of GDP over three years increases domestic demand relative to the base case through investment projects and stronger safety nets that provide targeted transfers to the poor of around 2 percent of GDP. These expenditures are financed with higher deficits and higher consumption taxes.

Enhancing economic potential: Advanced countries with external deficits could take a number of measures that include speeding up financial regulatory reforms to reduce financial uncertainty and reforming entitlement programs. Emerging market deficit countries could simplify product market regulation and increase the efficiency of the formal sectors to encourage more employment. Other reforms include product market reforms that encourage competition in network industries, professional services and retail distribution. The OECD estimates that even moving to 'best practice' product market regulation would raise productivity growth. Labor market reforms to increase the flexibility of labor markets, particularly in Europe, would also be growth-enhancing.

These changes would both enhance and provide more balanced growth through time. Current account deficits will decline as currencies depreciate, savings rise in advanced deficit countries and external demand for their products increases while in advanced surplus countries product and labor market reforms will enhance both investment and consumption. In emerging surplus countries reduced precautionary saving and higher infrastructure spending will boost domestic demand and imports which, with currency appreciation, help reduce current account surpluses.

Financial regulatory reforms: in the advanced economies at the epicenter of the crisis is another source of future growth. To restore organic growth financial institutions must also be willing to resume lending. A troublesome aspect of the recovery is the uncertainty around financial sector reforms, both because of pushback from powerful vested interests and the need to get the reforms right. In the troubled advanced economies support for the financial sector has to be unwound, banks' bad assets removed from their balance sheets and incentives changed to make support less attractive. Risks of future instability also need to be reduced and ways found to tackle future financial crises without taxpayer support. Financial reform legislation along these lines has been adopted in the United States but global standards are still needed to prevent new regulatory distortions that will affect cross-border capital flows. The Basel institutions are working towards defining new and safer standards for capital, liquidity and leverage ratios as well as capital buffers for approval by leaders at the Seoul summit.

Safeguarding trade liberalization and completing the Doha Round: Restoring trade liberalizing momentum would also help restore confidence essential to future growth. The IMF's downside scenario paints the risks of renewed recession. Jobless growth and rising structural unemployment in the run up to US midterm elections risks renewed protectionism and political pressures to turn back globalization. Few governments have much fiscal room to maneuver in the face of still-high unemployment and rely instead on external demand. If both deficit and surplus countries pursue the same strategy the threats of protectionism will rise. The return of the US trade deficit in June 2010 to a size not seen since the crisis began reflects both weaker-than-expected growth in exports, the weaker euro and resistance by major exporters in Asia and Europe to rebalance their economic growth. Up to now G20 leaders have repeatedly charged their trade ministers with finding ways to finish the Doha round; the issues are so technical that leaders have not directly intervened. Economists Gary Hufbauer and Robert Lawrence suggest a 7 potential catalyst for restarting the talks which leaders should consider. If China were to join the WTO government procurement agreement, as it has recently indicated it will do, and help restart the services negotiations the United States and Europe should agree to grant China the market economy status in anti-dumping and countervailing duty cases that it has sought for many years. An initiative of this kind which serves both the global interest in expanding trade and key interests of large countries could be the catalyst for other countries to rejoin and conclude the talks.

Where to with the Framework Process beyond Seoul?

The Framework is still young. Setting goals and evaluating alternative scenarios are a first step. Seoul will be expected to begin delivering results. These results will depend on individual countries, particularly the largest economies; but they will also depend on involving countries beyond G20 members though such institutions as the APEC summit in Yokohama which takes place immediately after Seoul:

The United States: A credible medium-term plan of fiscal consolidation is required, no matter the outcome of the political debates about its composition. This is unlikely until after the November 2010 mid-term elections, however, when the bipartisan National Commission on Fiscal Responsibility's report comes due. All options should be on the table, including a broad-based consumption or carbon tax as well as spending cuts. Policy initiatives to increase US exports in the next five years should be consistent with the global trade liberalization agenda.

China: As a major surplus country China's relatively fixed exchange rate implies that much of the burden of rebalancing must be carried by domestic policy changes. Domestic policies are moving to encourage the growth of domestic demand but more can be done. Structural reforms in the services industries that allow more competition would raise productivity. Further fiscal reforms to extend education services, infrastructure, public pensions and health insurance to the rural areas, along with labor market reforms that raise wages will help reduce high household saving rates. Raising artificially low input prices for energy, land, the environment and capital will change incentives for industrial production. And allowing exchange rate appreciation will facilitate these shifts, either *real* appreciation through higher domestic inflation or nominal appreciation.

Other Asians: One priority which Seoul organizers have recognized is that the Asian economies need to build confidence in macroeconomic stability through closer policy cooperation that encourages greater exchange rate flexibility and reliance on CMIM, rather than further building their own reserves, to provide liquidity if they run into balance of payment problems. Surplus East

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Asian economies could contribute more to global demand by reducing export incentives, increasing domestic demand through infrastructure projects and raising productivity in services industries by encouraging competition. They could make labor and product markets more flexible and encourage household consumption by creating social safety nets and developing domestic financial markets in ways that reduce credit constraints on households and small businesses.

G20 Co-chairs Canada and South Korea have successes from which others can learn. Few realize that Canada completed a major fiscal adjustment in the mid-1990s when it moved from a deficit of 8.7 percent of GDP to a small surplus helped by public support for consolidation, a growing world economy and a flexible exchange rate. Canada is now a paragon of fiscal and monetary prudence with an effective system of financial regulation. South Korea is a graduated 8 emerging market economy which introduced major structural reforms as it recovered from the Asian financial crisis more than a decade ago. Others can learn from South Korea's strategy to reduce export dependence through domestic investments in human capital, technology and a "Green Korea" strategy of energy conservation, clean energy R&D and energy efficient transportation.

Europe: Much of the uncertainty about global growth prospects emanates from Europe, so crisis management measures are important. The European stabilization fund and unprecedented central bank intervention have bought time for countries with sovereign debt problems to restructure their finances. But serious questions remain about economic governance in the euro zone where deeper coordination is required to restore and maintain fiscal prudence. Clearly future economic growth will depend on rising productivity which in turn will require politically-difficult and long-delayed product and labor market reforms in a slow-growth environment. Germany as the large surplus economy should stimulate domestic demand to facilitate such changes.

APEC: has a major role to play. The Yokohama summit on November 13-14 is strategically important to the overall G20 agenda. Given the importance of trade to its members APEC leaders should find a catalyst to restart and complete the Doha round. They should agree to strategic goals for the APEC growth strategy and follow through with deliverables in 2011 at Honolulu.

Communicating with Markets on Seoul Outcomes

A year after Pittsburgh Seoul faces a formidable communications challenge since tangible progress is expected on new standards to make global capital markets and institutions safer; policy changes that facilitate sustainable long-term growth and forward movement to conclude Doha. A Doha deal would be a strong signal as would final agreement on Basel targets for capital, liquidity and leverage ratios, commitments to living wills, and a process that delivers structural reform.

A signal of growing G20 legitimacy would be sent if the Yokohama APEC summit builds on the Seoul decisions in the APEC growth strategy involving more countries. Structural reforms on the G20 agenda are central to the five attributes of APEC's strategy of balanced, inclusive, sustainable, innovative and secure growth. These include regulatory reforms of services sectors, the financing and provision of infrastructure that deepens APEC connectedness and advances the low carbon economy, and capital market reforms to allocate capital resources more efficiently. Serious consideration should be given to appointing a high-level task force on structural adjustment to work out a regional strategy with milestones.

Other Asian regional institutions have potentially-supportive roles to play. The ASEAN+3 Macroeconomic Research Office, a surveillance mechanism which will begin work in 2011 to support macroeconomic cooperation, could provide institutional support for rebalancing by its members. Individual governments could establish independent expert commissions on structural reforms that help persuade publics of their importance. The US National Fiscal Responsibility Commission is one example. Singapore's Economic Strategies Commission chaired by the Minister of Finance and the Malaysian government's New Economic Model are others. These mechanisms could reduce the risks of the IMF's downside scenario being the outcome should governments opt for quick fixes and declare success.

IMF Reform: Immediate Agenda and Remaining Challenges

September 18, 2010
Sungmin Kim

1. Background

The International Monetary Fund (IMF) has been a central part of the global response to the financial crisis, and this has underscored the value of the IMF as a platform for global cooperation. It is also recognized that the IMF's capacity needs to be strengthened, to enable it to better respond to future crises and thereby support strong, stable and sustainable world economic growth. For this, it is essential to improve the IMF's legitimacy, credibility and effectiveness by reforming its governance and mandate.

At the 2008 November Washington Summit, G20 Leaders "underscored that the Bretton Woods Institutions must be comprehensively reformed so that they can more adequately reflect changing economic weights in the world economy and be more responsive to future challenges." Against this backdrop, at the 2009 September Pittsburgh Summit, G20 Leaders committed to a shift in quota shares and agreed that a number of other critical governance issues needed to be addressed. At the 2010 June Toronto Summit, they then clearly reaffirmed their commitment "to strengthening the legitimacy, credibility and effectiveness of the IMF, to ensure it succeeds in carrying out its mandate." One of the key objectives of these reforms is to reflect the changes in the world economy, in view of the strong growth in dynamic emerging markets and developing countries, including the poorest.

The deadline for IMF quota reform was pushed forward from January 2013 to January 2011 at the London Summit in April 2009, and at the Toronto Summit it was pushed up further to November 2010, when the G20 Leaders "called for an acceleration of the substantial work still needed for the IMF to complete the quota reform by the Seoul Summit and in parallel deliver on other governance reforms, in line with commitments made in Pittsburgh." This indicates the urgency that these issues be resolved by the November Seoul Summit. Given that the IMF reform has quantitative targets, and that the Leaders have themselves pushed the deadline for IMF quota reform forward twice, stressing the importance of IMF quota and governance reform, this agenda is also symbolic in the sense that it determines the credibility and sustainability of the G20 process itself. At the same time, completing this task is an important steppingstone for further reforms of the IMF and the international monetary system.

In this note, I will discuss some important issues related to this urgent agenda in the lead-up to the November Seoul Summit. I will then briefly touch upon remaining challenges.

2. Reform of IMF Quotas and Governance

2.1 Reform of IMF Quotas

The Leaders have committed to "a shift in quota share to dynamic emerging market and developing countries of at least five percent from over-represented to under-represented countries using the current IMF quota formula as the basis to work from." In interpreting this language, some emphasize a shift of at least 5 percent to dynamic EMDCs, while others underline the shift from over-represented to under-represented countries. There have been many discussions on whether the current formula should be altered or not. Should the current formula be used, due to the tightness of the timetable, it has been suggested that adjustments will also have to be made outside the formula.

As for the mechanism of the shift, the distribution of quotas could be achieved via a combination of selective (distribution in proportion to calculated quotas), equiproportional (distribution in proportion to existing quotas), or ad hoc quota increases.

The size of any increase in IMF quotas has a bearing on our ability to facilitate changes in quota shares. A substantial increase in quotas may be needed to achieve a shift in quota shares and to restore quota resources relative to global GDP to the levels agreed in the general quota reviews during the 1980s and 1990s. While many members have called for at least or up to a doubling of quotas, there are also proponents of a smaller increase in quotas, suggesting an increase in quotas that will allow for a 5% quota shift to be sufficient.

G20 leaders are also concerned with protecting the voting shares of the poorest members within the IMF. At Pittsburgh, they committed to "protecting the voting share of the poorest at the IMF." The voting shares of the poorest could be protected through an ad hoc quota increase for them as a group, or as individual countries. Another option is to increase the number of basic votes. Given the tight timeframe, however, it appears realistic that protecting the voting shares of the poorest through ad-hoc quota increases would be preferable to amending the Articles of Agreement of the IMF to change the number of basic votes.

2.2 Governance Reform

The G20 Leaders agreed in Pittsburgh that critical IMF governance issues need to be addressed as part of the quota review. These issues include: (i) the size and composition of the Executive Board, (ii) IMF Governors' involvement in strategic oversight of the IMF, (iii) open, transparent and merit-based selection of the heads and senior leadership of all international financial institutions, and (iv) enhancing staff diversity.

In their September 2009 London Communiqué, the G20 Finance Ministers and Central Bank Governors stated that "the voice and representation of emerging and developing economies, including the poorest, must be significantly increased to reflect changes in the world economy." In the area of Executive Board composition, the practical implication of this seems relatively straightforward -- that the composition of the Board should be realigned in such a way as to increase the voice and representation of emerging markets and developing economies on it.

However, the implication as to the size of the Board is far from clear. Obviously, there is a trade-off between size and efficiency. At the moment, most members support maintaining the Board's current size, while some support a reduction to enhance its efficiency.

There have also been discussions on how to enhance Governors' involvement in the strategic oversight of the IMF. This can be done through (i) activation of the Ministerial Council, (ii) enhancement of the IMFC, or (iii) establishment of the International Monetary and Financial Board (IMFB), a new decision-making ministerial body.

In Toronto, Leaders agreed to strengthen the processes of selection of heads and senior leaderships of IFIs in the lead up to the Seoul Summit, in the context of broader reform. There is general support for open, transparent and merit-based selection, irrespective of nationality, of the Managing Director and other senior management staff in the IMF. As to staff diversity, the IMF has been trying to ensure that its hiring policies help to increase regional and academic diversity and recognize prior work experience. G20 members have agreed on the importance of enhancing staff diversity, and will need to review the progress made by the IMF in this regard and identify possible areas for improvement.

2.3 Strategies for IMF Quota and Governance Reform

Through discussions at all levels, each country's position has been made clear, and the options related to some issues have been identified. The next step is for members to narrow down these options and work toward concluding the discussions in the spirit of compromise and with the resolve to deliver on the Pittsburgh commitments.

Korea, as the 2010 G20 chair, is working to facilitate discussions through the G20 WG for IMF reform, in parallel with the discussions in the IMF Executive Board and the IMFC Meeting, to reach agreement on these reform issues in the order of their priority. Going forward, this will involve first narrowing down the options as much as possible at the working level, and bringing forth a final political decision within the time necessary.

2.4 Possible Timeframe

Efforts need to be first made to achieve tangible outcomes by October 9 at the IMFC meeting. Should additional subsequent discussion be needed, the G20 Sherpas could provide political impetus through the Sherpa Meeting on October 14-15, in order for final agreement to be reached at the Meeting of G20 Finance Ministers and Central Bank Governors on October 22-23.

3. Remaining Challenges

As mentioned, the above agenda is an important steppingstone toward strengthening of the legitimacy, effectiveness and credibility of the IMF. Going forward, there remain many other challenges for improving the international financial system in general and the functioning of the IMF in particular. These include more ambitious issues related to reform of the IMF's mandate, such as improving the IMF's multilateral/financial sector surveillance, reforming its lending facilities, and strengthening the stability of the International Monetary System.

Regarding strengthening of the IMF's surveillance function, the crisis has demonstrated quite clearly how the interlinked nature of the global economy as well as the financial markets can lead to a crisis in one single country developing into a global one. A crisis in a "systemically important country (SIC)", in particular, can generate serious cross-border contagion effects.

This provides strong justification for strengthening the bilateral and multilateral surveillance functions of the IMF. At the same time, given the intertwined relationship between the macro-economy and the financial system, the IMF's financial sector surveillance should also be strengthened. This would require substantial collaboration with the Financial Stability Board and other international institutions, and mutual understanding would be needed on a clear division of labor and responsibilities between these institutions. More effort at the G20 level should be devoted to determining an appropriate way forward in this regard.

Meanwhile, the effective functioning of IMF surveillance depends critically on the willingness of countries to comply with the policy recommendations made during its surveillance process. One critical question in strengthening the surveillance functions of the IMF is whether there is scope for a "too-big-to-comply" problem. Such a problem, if it were to materialize among countries deemed to be "SICs", could bring about very serious consequences to the global economy.

Although the IMF's quota and governance reform could address such a "too-big-to-comply" problem to a certain extent, it is far from a complete solution to making sure of the effective functioning of the IMF's surveillance of "SICs". More effort should therefore be devoted to exploring other measures to make the IMF's surveillance more effective and binding.

In the area of reforming the IMF's lending facilities, since the 2008 outbreak of the global financial crisis, there has been marked progress made in improving its existing lending facilities and introducing new ones. In particular, we welcome the recent decision of the IMF Executive Board to introduce a Precautionary Credit Line and to improve its Flexible Credit Line. While acknowledging the progress made so far, however, we also feel that more effort should be put into further diversifying the instruments for tackling countries' temporary liquidity problems and discouraging them from huge accumulations of international reserves for self-insurance purposes.

Finally, one further key issue in the international financial system is how to address the growing instability of the International Monetary System (IMS). One potential source of growing instability of the IMS is the fact that there are few key reserve currencies in it at the moment. One potential problem with having a small number of key reserve currencies is that occurrence of "key reserve currency crunch", a severe shortage of supply of key reserve currencies, is more likely than would otherwise be the case, as evidenced by the severe "dollar crunch" in the international financial markets during the recent crisis. Another potential problem associated with having a limited number of key reserve currencies, combined with large volumes of international reserve accumulation, is that since most of the accumulated reserves are invested in the financial markets of a few key reserve currency countries, this could possibly lead to asset price bubbles in the countries with those key reserve currencies. And to a certain extent, in fact, this contributed to generating the housing market bubble in the United States during the pre-crisis period -- by allowing the level of its long-term interest rates to remain abnormally low. In this regard, we welcome the French initiative to address this issue as chair of the G20 next year.

Note for G-20 working group on international safety nets

September 18, 2010
Olivier Jeanne
Johns Hopkins University, NBER, CEPR and Peterson Institute for International Economics
Philippe Martin

The working group co-chairs ask for our views on the "ways in which the international financial architecture can be strengthened in order to better support countries who experience volatility in capital flows and foreign liquidity shortages as a result of macroeconomic and financial shocks."

To be properly addressed, this question should be put in the context of all the policies and instruments that are used by countries to insure themselves against macroeconomic shocks. Countries can insure themselves in several ways: by hedging, by accumulating international reserves, by relying on crisis lending from the IMF (or other international arrangements), or by prudential capital controls that may reduce their vulnerability to balance-of-payment crises. This broad set of policies has been called "macro-insurance" or "country insurance" (Becker et al, 2007). The microeconomic theory of insurance is indeed rich of insights that can be transposed to country insurance—although with important caveats as explained below.

We will organize our remarks around three areas:
• Self-insurance by hedging or through the accumulation of international reserves.
• Collective insurance through international liquidity arrangements.
• The possible role of capital controls.

1) Two puzzles in country insurance: insufficient hedging and excessive reliance on international reserves

As crises have revealed time and again, private and public agents seem to under-hedge against a variety of macroeconomic risks. It is important to understand the source of this failure in order to determine the appropriate policy remedies.

Insufficient hedging could be due to an inappropriate supply of hedging instruments. For example, there are no market instruments to deliver state-contingent liquidity at the domestic or international level, although such instruments are conceivable (Caballero, 2009). The hedging instruments that do exist are often relatively underdeveloped (e.g., GDP-indexed bonds, catastrophe bonds), or suffer from significant limitations (e.g., short maturities for commodity derivatives). The development of these markets might be impeded by oordination problems that prevent achieving critical mass and standardization. It has been suggested that the main role of the public sector should be to catalyze the supply of financial socially useful innovation(Caballero, 2003).

A failure of supply is only part of the story, however. Hedging also seems to be excessively low on the side of demand. Even the hedging instruments that exist, and are sometimes available in large and liquid markets, seem underused.[1] There are several reasons that demand could be excessively low. Individual economic agents might fail to internalize the systemic effect of their hedging, in which case the appropriate policy would be to encourage hedging through regulation. The externality argument, however, is not a plausible explanation for why even governments often under-hedge their risks. Other impediments could include the reputational costs of running losses on hedging positions, or the short horizon of policy-makers. One way of reducing those impediments would be for the international community to endorse—for example, through the IMF—a code of good practice for government hedging policies, and to certify those policies.

The appropriate policy response to excessively low hedging, thus, is very sensitive to the nature of the underlying market failure. From this point of view, it seems difficult to make strong policy recommendations without a well-established diagnosis of the impediments to hedging. We would suggest that the international community—perhaps through the IMF and the World Bank—make a major effort to better understand the conditions under which the public sector might foster more socially useful financial innovation.

Given the insufficient level of hedging, another way that governments can self-insure is by accumulating international reserves. One of the most important trends in international finance is the dramatic rise in international reserves in developing and emerging market countries since the beginning of the 1990s (see Figure 1). As shown by Figure 2, international reserves have increased much more than one would predict based on the two main “rules of thumb” for reserves adequacy: that reserves should cover three months of import, or one year of short-term external debt—the so-called “Greenspan-Guidotti rule”. The ratio of reserves to money supply has also increased, although to a lesser extent as emphasized by Obstfeld, Shambaugh and Taylor(2008).

The buildup in international reserves of emerging markets countries has been attributed to a desire to insure against volatile capital flows.[2] Although this is certainly a plausible motive, we do not believe that it explains the bulk of the reserves accumulation, for a number of reasons.First, the trend started in the early 1990s, before the 1994-95 Mexican crisis or the 1997-98Southeast Asian crises alerted emerging market countries to the risk of volatile capital flows(Figure 1). Second, international reserves increased much more than short-term external debt,although short-term debt is a good measure of a country’s vulnerability to a sudden stop incapital flows (Figure 2).[3] Third, many developing and emerging market countries have moved

[1] For example, the total open interest position on the two largest markets for oil futures, the NYMEX and the Intercontinental Exchange (ICE), amounts to less than 0.2 percent of known oil reserves (Borensztein, Jeanne and Sandri, 2009).

[2] For example, in the words of Joseph Stiglitz: ”The East Asian countries that constitute the class of ‘97—the countries that learned lessons of instability the hard way in the crises that began in that year—have boosted their reserves in part because they want to make sure that they won’t need to borrow from the IMF again. Others, who saw their neighbors suffer, came to the same conclusion—it is imperative to have enough reserves to withstand the worst of the world’s economic vicissitudes” (Stiglitz, 2006, p.248).

[3] This was precisely the reason to propose the Greenspan-Guidotti rule as a substitute to the old three-months-ofimports rule after the 1994-95 Mexican crisis. The idea was to take into account the fact that the source of balance of- payments vulnerability had shifted from the current account to countries’ external balances sheets. However, the Greenspan-Guidotti rule does not do a better job than the old rule at explaining the observed accumulation of reserves (Figure 2).

away from fixed exchange rates, and the fixed pegs that remain often do not need to be sustained by a large amount of reserves.[4] Fourth, the observed accumulation of reserves is difficult to explain by a cost-benefit analysis of the precautionary motive (Jeanne, 2007; Jeanne and Rancière, 2008). The countries that accumulated the most international reserves—China and other Asian countries—are those that are the least vulnerable to crises that would require the use of those reserves.[5]

An alternative explanation for reserve accumulation in developing Asia is that it is the byproduct of high saving rates or of foreign exchange interventions to keep the currency competitive (the so-called "Bretton-Woods II" view exposed by Dooley, Folkerts-Landau and Garber, 2004). Indeed, the reserves have been accumulated primarily through current account surpluses, leading to global financial imbalances.[6] Whether the main motive was insurance or not is important because this determines the likely impact of developing international liquid arrangements on global financial imbalances (see below).

2) International crisis lending arrangements are developing but this is unlikely to have a large impact on the accumulation of international reserves.

The basic welfare case for pooling reserves is simple, and essentially the same as for risk pooling in car or fire insurance. The reserves are allocated to the countries in need, allowing an efficient reduction in the total amount of reserves, which can be invested in socially more productive uses.

However, there is one important difference between classical insurance and international liquidity arrangements. The reserves are *lent*, not transferred, by the insurance arrangement to the crisis country. This has an important implication: one must ensure that lending is repaid, which generally requires the imposition of conditionality on the borrowing country. This conditionality is different from the measures that are used to limit moral hazard in car or fire insurance, which aim at reducing risk-taking *ex ante* (before the realization of the risk). In the case of crisis lending, the goal is to ensure repayment *ex post*.[7] The effectiveness of conditionality relies on providing the appropriate incentives to the borrowing country (in particular, through monitoring

[4] For example, who would argue that China needs a large amount of reserves to defuse the risk of a speculative attack leading to a *devaluation* of its currency? However, it is mainly the risk of a speculative attack against a fixed peg, or of run on dollar deposit, that justifies maintaining a high ratio of reserves to M2.

[5] In this regard, we would suggest that the IMF request its member countries to provide a tentative cost-benefit analysis of the appropriate level of reserves held for precautionary reasons in the context of its annual article 4 consultations. The IMF would simply record each country's analysis. Presumably, comparing notes across countries and over time would generate some multilateral discipline, as it would be difficult for a country to change its criteria every year so as to justify an increasing level of reserves.

[6] An increase in international reserve holdings does not necessarily require a current account surplus: it can be financed instead by issuing long-term external debt. Such balance-sheet operations are probably a more efficient way of accumulating precautionary reserves than distorting the real exchange rate to generate a trade surplus. That it was not the preferred method is indeed one more sign that the reserves were not accumulated primarily for precautionary reasons.

[7] This idea is captured by Tirole's (2002) view of the IMF as a "delegated monitor". See Jeanne, Ostry and Zettelmeyer (2008).

and peer pressure).[8] Both aspects of international crisis lending arrangements—risk pooling and conditionality—are key to understand and analyze the recent developments in this area.

The resources of international liquidity arrangements have expanded, both at the multilateral and at the regional levels. The G20 economies agreed to triple the Fund's lending capacity to $750 billion. Asian countries have made progress toward transforming the Chiang Mai arrangement into an Asian Monetary Fund. Looking forward, a "European Monetary Fund" has been discussed as a way of dealing with government debt crises in the euro area.

Although this development could be justified as international crisis lending catching up with the higher volume of capital flows, it is paradoxical in more than one way. First, if the accumulation of reserves is already excessive at the country level, what is the benefit of bolstering international arrangements? The answer is probably (as we have argued above) that the countries that have accumulated the most reserves are not those who need them the most for precautionary reasons.

Second, the benefits of *regional* arrangements seem difficult to understand from the perspective of insurance. Since crises are more often regional than global, the gains from pooling risks would seem to occur primarily between regions, not inside regions. It may be that the purpose of such regional mechanisms is not only insuring members of the insurance pool but also preventing a country specific crisis from spreading to the rest of the region though contagion. The regional dimension here comes from the regional scale of the externality that goes through trade and financial linkages. However, IMF lending can be supplemented with regional resources (as was the case for example in the 1994-95 Mexican crisis) on a case-by-case basis and without creating a regional institution.

It is sometimes argued that a collateral benefit of enhancing international liquidity arrangements will be to mitigate global financial imbalances by reducing the developing countries' demand for international reserves. However, we would argue that this effect is unlikely to be large. First, crisis lending is not a perfect substitute for a country's own reserves, because of conditionality and of the uncertainty surrounding the access to lending in a crisis. Second, a large fraction of reserves does not seem to be accumulated for precautionary reasons—as we argued above—so that bolstering collective insurance is unlikely, per se, to significantly curb the trend of accumulation.

There are also significant developments in the area of conditionality. The IMF is reforming its conditionality, which was criticized for being intrusive and biased following the 1997-98 Southeast Asian crisis.[9] The IMF streamlined the conditionality on its lending facilities and

[8] The evidence suggests that IMF conditionality has been effective in that regard (Jeanne and Zettelmeyer, 2001).

[9] The debates on the "excessive intrusiveness" of IMF conditionality often reflect deeper disagreements about the boundaries of national sovereignty and "droit d'ingérence". To take an extr[9]eme an example, IMF conditionality that leads to unseat a "bad" policy-maker in a crisis country will be deemed excessively intrusive by this policymaker, not necessarily by the country's citizens. This being said, the IMF is mandated by the governments of the member countries, not directly by their citizens.

created a new facility, the flexible credit line (FCL), with little *ex post* conditionality for countries with good fundamentals. The FCL was inaugurated by Mexico, with Poland and Colombia quickly following suit.

The FCL is a positive and interesting development. It has met some demand but remains to be tested in a crisis situation—no country having drawn on it so far. One benefit of the FCL is to make the access to crisis lending more assured for countries with good fundamentals. From this point of view, it would be desirable to make the conditions that countries must satisfy to qualify to the FCL more predictable too. The IMF staff reports explaining the reasons why a country has been approved for the FCL could make the general criteria underpinning this decision more explicit.[10]

Conditionality may also give us a key to understand the *raison d'être* of regional crisis lending arrangements. For example, the main purpose of an arrangement such as the Asian Monetary

3) Prudential capital controls should play an increasing role in reducing macroeconomic risks looking forward

Financial opening in emerging market countries may have benefits in decreasing the cost of equity capital and can have a positive effect on domestic investment. However, the economic gains of international financial flows seem modest for developing and emerging market economies (Gourinchas and Jeanne, 2006). Moreover, a voluminous literature surveyed by Aizenman (2004) emphasizes the risks of liberalization and the vulnerability of emerging market financial systems to capital mobility. By making borrowing on world financial markets easier, financial liberalization may strengthen market failures (moral hazard and credit constraints) that are prevalent in emerging markets. Even in the absence of market failures, emerging markets can become vulnerable to a self-fulfilling driven financial crash and capital flight when capital flows are liberalized between emerging markets and rich countries (Martin and Rey, 2006). This also raises the question whether financial integration should be encouraged at the regional level rather than at the global level and how the trade-offs between the forms of integration can best be managed (Martin 2010).

Against this background, the conventional wisdom on capital controls is evolving. Chile has a long experience with prudential capital controls on inflows and some countries have introduced such controls in the current crisis. Recent research allows us to understand better the welfare case for optimal capital controls. For example, capital controls can mitigate booms and busts in capital flows and asset prices (Jeanne and Korinek, 2010). From this point of view, controls can be viewed as one component of the new macro-prudential policy framework that has been called for since the global financial crisis. The benefits of capital controls must be waited against their costs, which are many and have justified the opposition of the IMF to their use. This opposition is however softening (Ostry et al, 2010), which we see as a positive development. Looking

[10] Another approach would be to base prequalification on quantitative criteria à la Maastricht. We would advise against it because of the need to preserve flexibility. Fund might be to develop a "regional conditionality" perceived to be more legitimate and effective than that of the IMF, and perhaps to influence IMF conditionality in the region by providing a local alternative. Looking forward, this raises the question of the respective roles of the IMF and regional arrangements in defining conditionality.

forward, the IMF should play a more active role and develop with its members a code of good practice for prudential capital controls.

Concluding points

Improving the international financial architecture requires both a strengthening of insurance mechanisms against macroeconomic risks and of policy tools to reduce the macroeconomic risks themselves. On the first point, the development of hedging instruments should be fostered by the international community, which can be a catalyst in the supply of socially useful financial innovation. International crisis lending arrangements have an important role to play, but we argued that the demand for international reserves and global financial imbalances are unlikely to be significantly affected by the strengthening of those arrangements. Finally, macroeconomic risks that take the form of destabilizing capital flows can be reduced by prudential capital controls, for which the IMF should define a code of good practice.

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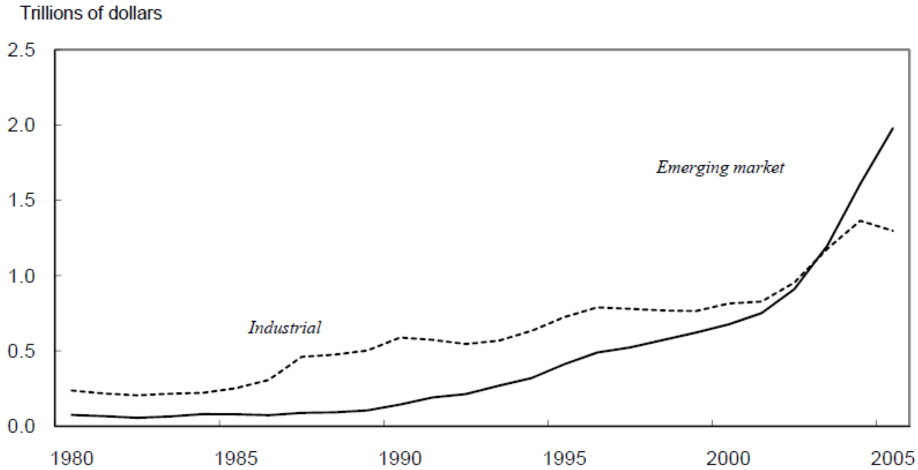
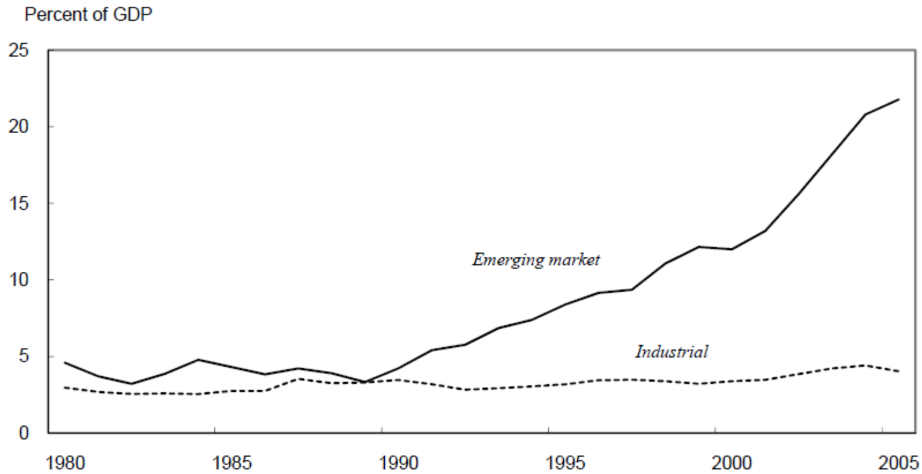
Figure 1. International Reserves in Emerging Market and Industrial Countries, 1980-2005a

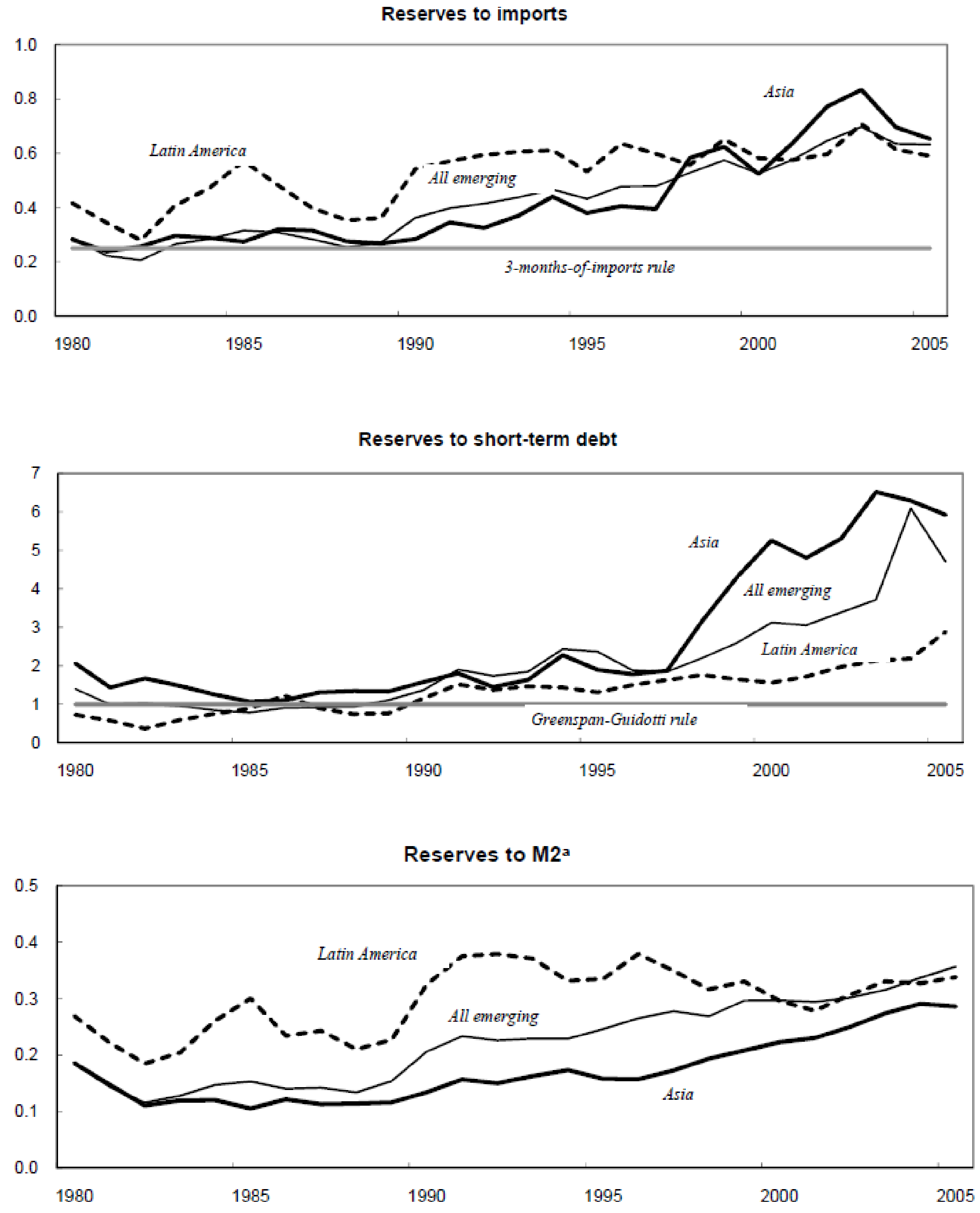


Sources: IMF, International Financial Statistics; World Bank, World Development Indicators.



a. Total reserves minus gold.

Figure 2. Reserve Adequacy Ratios in Emerging Market Countries, 1980-2005



Sources: IMF, International Financial Statistics; World Bank, Global Development Finance.
a. The conventional range of the reserves-M2 ratio is 5 to 20 percent.

Korea's Leading Think Tank

Development Agenda for the G20

Wonhyuk Lim
Director of Policy Research
Center for International Development

KDI

The G20 and Development: Two Big Questions

KDI

- **What can development do for the G20?**
  - Inclusiveness
  - Issue expansion
  - Representativeness legitimacy and effectiveness legitimacy
- **What can the G20 do for development?**
  - Should the G20 try more of the same or something different?
    - IFIs: Post-Washington Consensus
    - East Asia's Development Experience
    - G8: Aid-Centric Development Agenda and Partnership with Africa
    - UN: Millennium Development Goals
    - Human Development, Economic Growth, and Poverty Reduction
  - How can the G20 deliver on its promises?
    - Funding and delivery mechanism
    - Executive agency: secretariat?

Breakdown of the Washington Consensus

- **Washington Consensus 1: Stabilize, Privatize, and Liberalize**
  - Skepticism from practitioners and scholars familiar with East Asia's economic development even at the height of triumphant neoliberalism
- **Washington Consensus 2: Get the Institutions Right**
  - "Picking Winners" in Another Guise?
  - Local context of institutional innovations
- **Disillusionment with the Washington Consensus**
  - Disappointing performance of "structural adjustment"
  - Low popular support as a rationale for aid giving
- **Search for a New Consensus**
  - Institutional Fundamentalism
  - Human Development and Poverty Reduction: MDGs
  - Bootstrapping Approach: New Light on East Asia's Experience

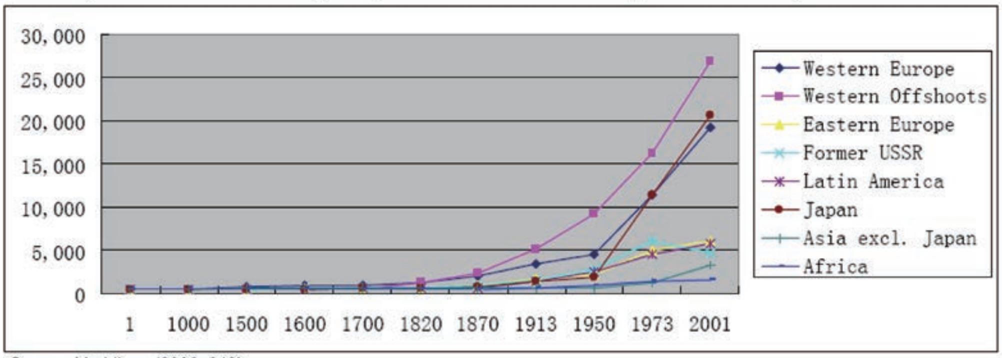
Alternative Views on Development

- **Endowment View: Framework Approach (Liberalization)**
  - Economies with "appropriate endowments" (cultural values, institutions, "investment climate") grow. Those lacking such endowments do not.
    - Examples: Protestant ethic, common law, and colonial legacies
  - The state should focus on getting the institutional framework right and release market forces and let individuals play the game.
- **Evolutionary View: Ingredients Approach (Capacity Building)**
  - Initiating growth does not require state-of-the-art institutions. The challenge is not so much getting growth to start by adopting big-bang reforms, as to <u>sustain</u> it by devising search networks to detect and mitigate constraints as they emerge.
  - The reinforcement of successful experiments through the feedback mechanism of performance-based rewards can lead to dramatic changes over time.
  - The state should facilitate growth by supplying the missing ingredients, which are often characterized by externalities.
  - While a regime that facilitates resource mobilization can be effective in a catch-up phase of development, an institutional platform that fosters autonomy, diversity, and experiment is critical to sustained productivity-led growth.

Conceptual Framework for Development

- "Development as Freedom"
- "Modern Growth" and Increasing Returns: Two Breakthroughs
  - Emergence of a large group people who absorb and assimilate knowledge to improve their human capital and in turn use their improved human capital to apply and generate knowledge to raise productivity (Lucas 2009)
  - Expansion of markets and hierarchies to facilitate specialization and coordinate productive activities, through the invisible hand (Smith 1776) and the visible hand (Chandler 1977)

Per Capita GDP of Various Regions (in 1990 international Geary-Khamis dollars)



Source: Maddison (2006: 642)

Conceptual Framework for Development

- **Development: Centrality of Innovation and Coordination Externalities**
  - Development is conceptualized as the result of synergies between enhanced human capital and new knowledge, involving complementary investments in physical and social capital. Innovation and coordination externalities are central.
  - The fundamental policy challenge is for the state to work with non-state actors and markets to address innovation and coordination externalities while minimizing negative government externalities (e.g., incompetence and corruption).
  - A solution to this challenge should include an incentive system that uses markets and institutions to provide rewards based on individuals' contributions to society in a competitive setting. Multiple solutions are possible.
- **Innovation**
  - Knowledge as a Public Good: Non-Excludability and Non-Rivalry
  - Knowledge as an Evolving Organism: Autonomy, Diversity, and Experiment
- **Coordination**
  - Transaction Costs and Complementarities
  - Capacity of the State, Non-State Actors, and Markets
- **Performance-Based Reward System**
  - Equality of Opportunity
  - Protection of Property Rights

Conceptual Framework for Development

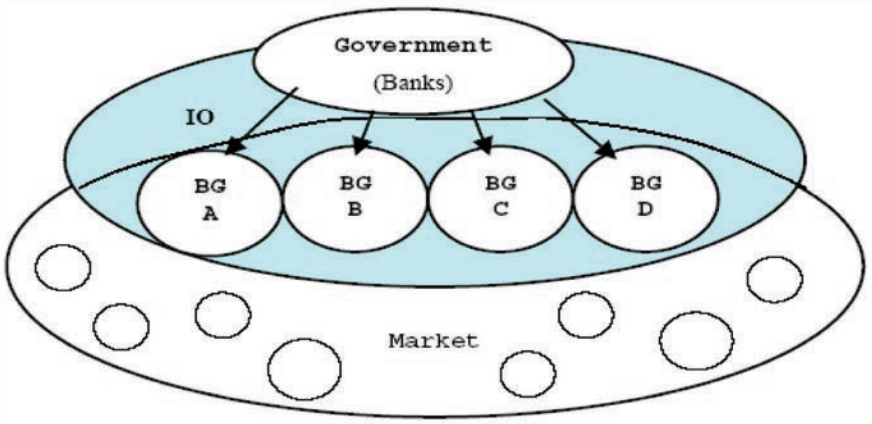
Respective Roles of the State, Non-State Actors, and Markets

- The development of markets reduces at least some of innovation and coordination externalities over time and facilitates specialization as well, and the importance of autonomy, diversity, and experiment in sustaining growth also places normative restrictions on the extent and mode of state intervention.
- These restrictions should be shaped by three factors: 1) the development of markets to coordinate productive activities; 2) the level of state capacity (competence and integrity) to address externalities; and 3) the availability of non-state actors (e.g., business groups) to internalize externalities.

Dynamics and Transition

- As the capacity of the state, non-state actors, and markets changes over time, their respective roles and the normative restrictions on the extent and mode of state intervention should also change.
- However, path dependence, involving historical and political economy factors, may affect this dynamics and create a problem of transition.

National-Level Coordination: Government, Business Groups, and Markets



Firm- or Group-Level Coordination: Internal Hierarchy and External Market

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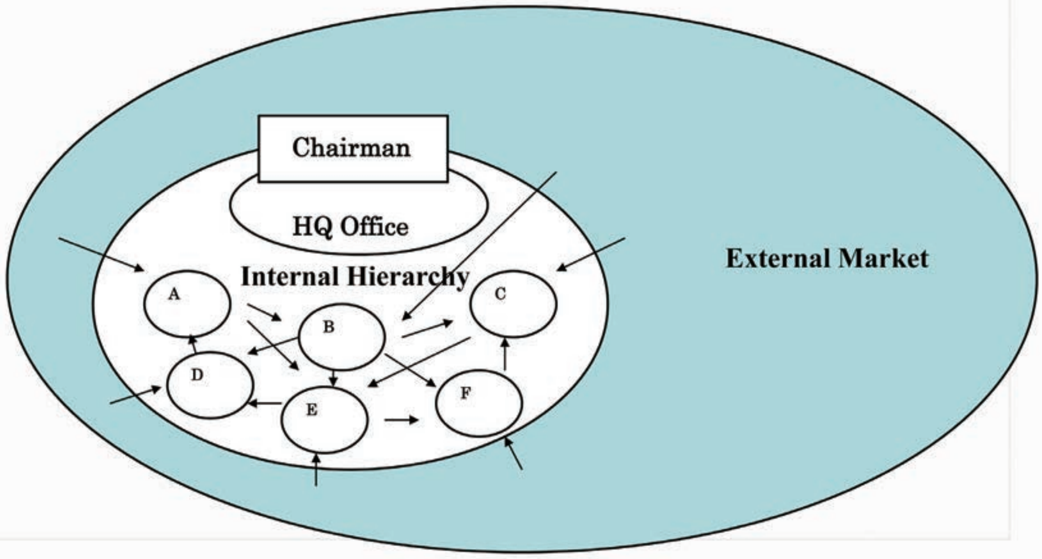


Lessons from Korea's Experience

KDI

- **Compelling Vision and Leadership: Rapid, Shared Growth**
  - Vision that Imparts a Shared Sense of Purpose
  - Broad-Based Growth: Beyond Enclaves and Dual Economy
  - Appeal to Nationalism, Legitimation of Political Power Through Economic Modernization (after 1960 and 1961), Inter-Korean Competition
  - Sustained Personal Attention from Top Leadership: Combination of Multi-Year Plans and Monthly Meetings
- **Evolutionary Approach: Pragmatism and Feedback**
  - No Ready-Made Model to be Taken off the Textbook: "Big Push" / Import-Substituting Industrialization, Taiwan's Export-Led Industrialization, Japan's Spillover Industry Promotion
  - A blueprint (indicative plan) operates as a provisional goal which is constantly revised, based on an informed discussion of where the experiment in question is going.
  - "We can make mistakes as long as we can correct mistakes. We can get feedback from the global market."

Lessons from Korea's Experience

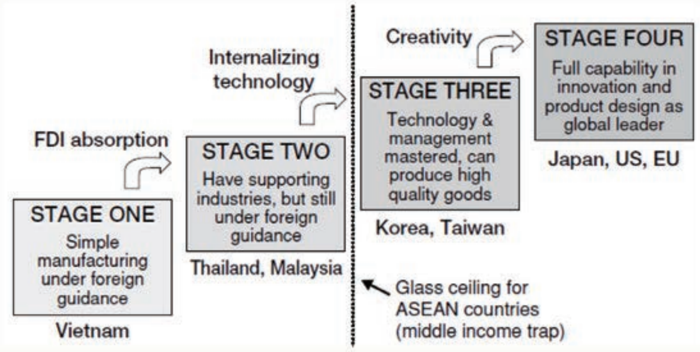
- **Big-Push Partnership: Information and Risk Sharing**
  - Information, Incentive, and Decision-Making Shared by the Government and the Private Sector
  - Controlling Corruption and Rent-Seeking
  - Developmental State: Autonomy from Particularistic Interests *and* Responsiveness to Popular Pressure
  - Problem of Transition: Danger of De-Control without De-Protection
- **Export Orientation: Market Test for Government Policy and Corporate Performance**
  - Less Prone to Political Influence and Manipulation: Reward Based on Performance in a Competitive Setting
  - Exploiting Scale Economies and Overcoming the Limits of Domestic Market
  - Learning by Exporting: Upgrading Mechanism

Lessons from Korea's Experience

- **Outward-Oriented, Bottom-up, Integrated Industrial Policy**
  - Go from downstream to upstream. Start with what you have. Exploit comparative advantage ("Big Push" through trade). Wait until domestic and export demand becomes large enough to justify the construction of optimal-scale plants. Insist on international competitiveness from the outset.
  - Accumulate skills. Make a transition from imitation to innovation.
  - Set up public-private search networks to address emerging problems
- **Inward-Oriented, Top-down, Ad Hoc Industrial Policy**
  - Promote upstream industries with large spillovers ("Big Push" through coordinated domestic industrialization).
  - Go top-down. Disregard feedback.
  - Problem: Insufficient Demand, Suboptimal-Scale Plants, Higher Costs, Monumental Projects

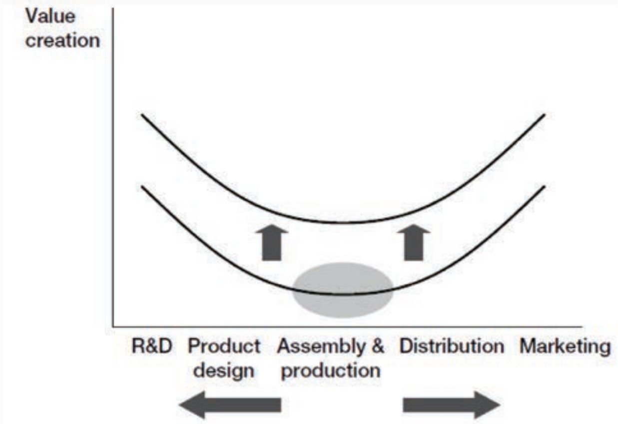
Korea retained the ownership of its industrialization, acquired and assimilated foreign technology and know-how, and progressively developed its own capabilities, relying primarily on foreign debt rather than FDI.

Overcoming the Middle Income Trap



Source: Ohno (2009: 8)

Smile Along the Value Chain



Source: Economic Planning Unit of the Prime Minister's Department, Malaysia (edited).

Differentiating the G20 and G8 Approaches to Development

KDI

Principle	G20 approach	G8 approach
Strong, sustainable and balanced growth	Focus on growth	Focus on welfare/poverty
	Global structural transformation	Country structural adjustment
	Systemic risk management	Mitigate impact of shocks
Need for collective action	Coherent policies towards development	Focus on aid
	Model good practice	Define homogeneous standards
	Reduce free-riding through dialogue and common understanding	Enforce global rules
Tangible results	Implementation focus (templates/scorecards)	Announcements focus
	Common accountability framework	*Ad hoc* accountability mechanisms
	Significant legacy agenda	Fresh agenda each meeting
Legitimacy and Relevance to others	Global economic governance	G8 rules
	Middle income and low income development issues	Low income focus, especially Africa
	Involve regional organizations	Invite specific countries

Source: Kharas (2010)

Millennium Development Goals (1990-2015)

KDI

-Recognition of Poverty
-Statement of Good Intentions
-Establishment of Global Partnership

-Statist and Technocratic in Conception
-Driven by Donors
-Focused on Basic Human Needs
-Insufficient for Self-Generating Growth

-Simplicity and Measurability
-Focus on Ends rather than Means
-No Regard for Different Initial Conditions
-Different Levels of Abstraction

MDGs beyond 2015: Aid to End Aid?

KDI

- **New Baskets**
  - Basic and Process Freedoms: "Development as Freedom"
  - Inclusive Growth
    - "improved lives for slum dwellers" (Target 7.D)
    - access to finance
  - Infrastructure
    - ICT indicators (Target 8.F)
    - Electricity
    - Transportation
  - Industrial Development?
- **Consolidated Basket: Basic Health**
  - Child mortality (MDG 4)
  - Maternal health (MDG 5)
  - Diseases (MDG 6)
  - "Sustainable" access to safe drinking water and basic sanitation (Target 7.C)
- **Enhanced Basket: Education**
  - Primary education (MDG 2): focus on quality and completion
  - Technical education and vocational training

G20 Development Agenda: Focus on Growth and Resilience

KDI

- **Premier Marketplace for Development Paradigms**
  - The G20 consists of advanced industrial countries and leading developing countries. Interaction between the two groups within the G20 is bound to lead to intellectually stimulating and influential discussion on what really works for development.
- **Alignment with the G20 Framework**
  - The G20 development agenda is focused on promoting development for "strong, sustainable and balanced growth."
  - Facilitating multi-polar growth helps to address global imbalances and may represent a win-win solution for the developing and developed worlds.
- **Complementary and Differentiated Approach**
  - The G20 development agenda points to the importance of sustained economic growth in achieving human development.
  - It emphasizes industrial, trade, and infrastructure development while acknowledging the importance of market institutions and human development.
  - It recognizes the centrality of innovation and coordination externalities for development, and understands that multiple paths to development are possible.

G20 Development Agenda: Key Pillars

KDI

Pillars	Elements
Infrastructure	-Data & Analysis -Private Participation in Infrastructure (PPI) -Regional (Cross-Border) Infrastructure
Human Resource Development	-Education Quality -Technical Education and Vocation Training
Trade	-Aid for Trade -Duty Free / Quota Free
Private Investment & Job Creation	-Ease of Doing Business
Financial Inclusion	-Financing for Job Creation
Growth with Resilience & Food Security	-Insurance and Futures Markets -Agricultural Development
Governance	-Anti-Corruption -Tax Reform
Knowledge Sharing	-Knowledge Sharing Platforms -South-South and Triangular Partnerships

G20 Development Agenda: Implementation

KDI

- **Funding**
  - Outcome orientation: Avoid unrealistic aspirational commitments, and concetrate on significant, achievable, and accountable measures.
  - No real discussion yet of resource commitments
- **Partners**
  - Mutually accountable partnership: Engage "low-income countries (LICs)" as equal partners.
  - Private sector orientation: Promote private sector involvement and innovation
- **Executive Agency: Secretariat**
  - Leadership by Chair
  - Troika-based staggered secondments
  - Technical staff

The G20 must establish an effective implementation mechanism and link its development agenda to the revision of the Millennium Development Goals if it is to enhance its representativeness and effectiveness legitimacy through development.

Korea-Canada-France
G20 Seminar

17-18 September 2010, Lotte Hotel Seoul, Republic of Korea

Paper

Global Economy and Framework

September 18, 2010
Dongchul Cho

1. Global Crisis and the G-20

The recent crisis that broke out in September 2008 sparked bold policy reactions in the global community. In many countries, interest rates were lowered to near-zero and fiscal deficits were greatly expanded. Many emergency measures to rescue financial markets were also taken simultaneously. History will record the past 2 years as the period of the most active policy coordination across countries, and place the G-20 summit meeting at the heart of this critical event.

Thanks to these policy efforts, the global economy turned around from the second half of last year. This was truly a big achievement, considering the panic of the market in 2008 when analysts and commentators pushed out extremely gloomy forecasts and referred to the trauma of the Great Depression. After two years, however, Michael Bordo (2010) concluded "the economic impact of the Great Depression dwarfed that of the recent crisis," based on his study on crisis experiences since 1880.

This success was not achieved without cost; it was accompanied with huge costs, particularly in fiscal soundness. Budget deficits in 2009~2010 were expanded to obviously unsustainable levels in many countries, resulting in explosive increases of public debts to the levels that the market began to concern. In fact, the 'unprecedented' impact of the recent global crisis was not manifested on GDP or employment but on public debts. Further stimulation by fiscal policy, at least in some countries, could rather destabilize the global financial market, as was evidenced by the case for some South European countries in the first half of this year. Faced with this development, the G20 summits at the Toronto meeting in June announced, "Advanced economies have committed to fiscal plans that will at least halve the deficits by 2013 and stabilize or reduce the government debt-to-GDP ratios by 2016."

Session 1: Global Economy and Framework

This stance of the G-20 for fiscal consolidation has been challenged whenever downside risks emerged and financial markets jittered. As long as macro-policies are based on uncertain forecasts about the future, it is impossible to design an unarguable policy stance, *ex ante*. Nevertheless, identifying and checking relevant issues are always proven fruitful in minimizing the probability that we end up with regrets about policy mistakes, *ex post*.

2. Global Economic Prospect and Assessment

In order to properly discuss macro-policies at the G-20, the following issues regarding economic prospect need to be examined:

(i) Is 'double-dip' a likely scenario?

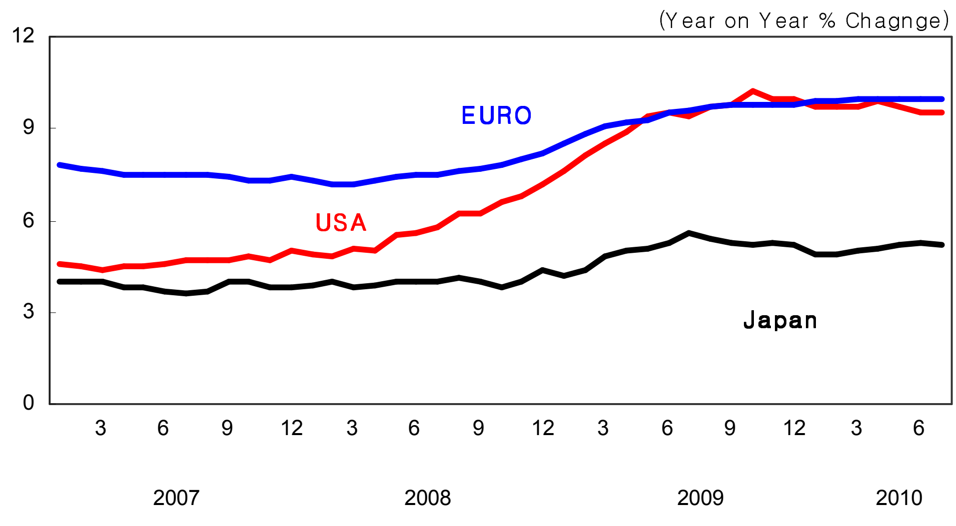
(ii) Is the recovery to the pre-crisis level an appropriate reference?

(iii) Is there a risk that growth slowdown is structural rather than cyclical?

(i) 'Double-dip'?

Despite economic recovery, unemployment rates remain high and non-performing loans have not been significantly reduced in many advanced countries (Figure 1). Against this backdrop, if fiscal stimulus is rapidly withdrawn, it may hamper overall recovery momentum --- according to the double-dip scenario.

Figure 1: Unemployment Rates

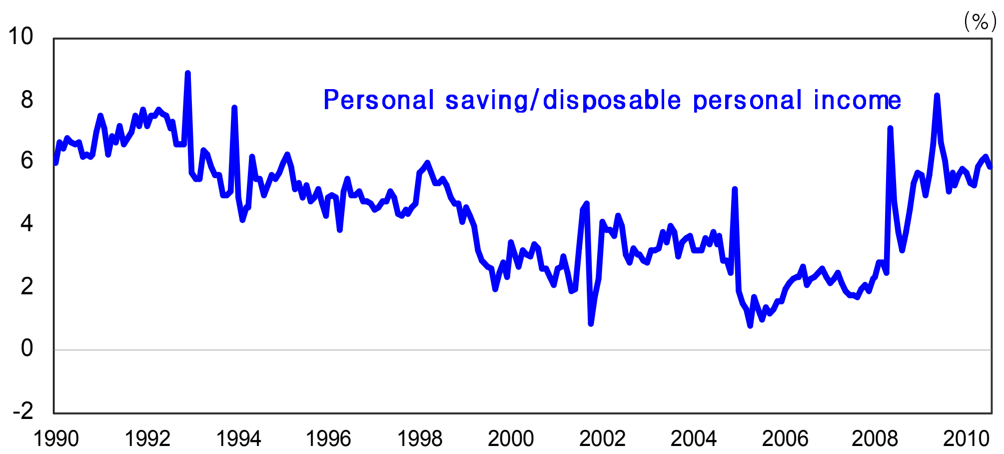


Source: Eurostat(Euro), Census Bureau(USA), Statistics Bureau(Japan).

This is a risk scenario, however. The base-case scenario in most forecasts including the IMF's and OECD's is a slow but steady recovery over the years to come (at 4~5% of annual growth for the world and 2~3% for advanced countries). Private sector's recovery momentum is being accumulated and fiscal consolidation is projected to be carried out gradually. The fiscal consolidation plan recommended by the G-20 also provided a reasonable degree of short-term leeway for gradualism. While a plan B needs to be prepared for a risk scenario, the plan A should be based on the base-case scenario of the consensus forecast.

A related issue is how deep it would be and what would be its main cause, if a double-dip scenario were realized. Since the Lehman Brothers bankruptcy filing, major risk factors in the private sector have been revealed and adjusted to an extent. In particular, the potential risks associated with asset market bubbles have been reduced to the extent that asset prices have been corrected. The US consumers' saving rate, which had long been pointed as a warning signal, also restored its pre-bubble period level (Figure 2). Even for a pessimistic scenario, it seems unlikely that such a panic as the one in September 2008 will resurge.

Figure 2: US Personal Saving Ratio



Source: U.S. Department of Commerce, Bureau of Economic Analysis.

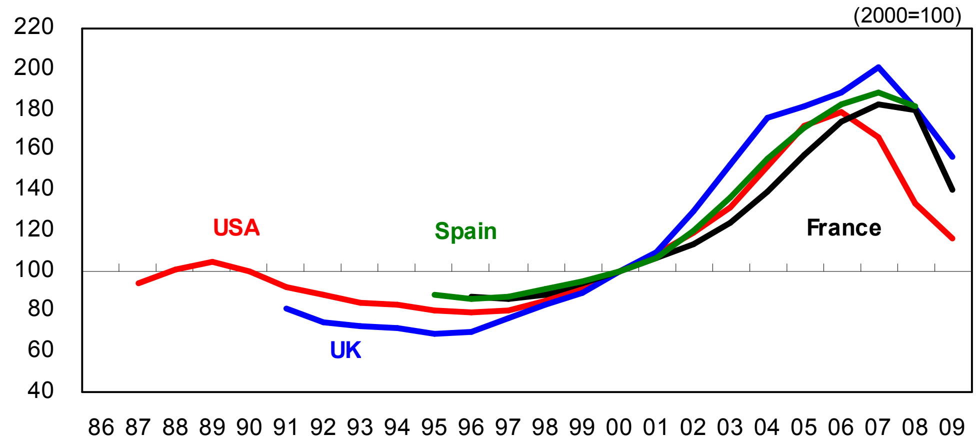
While the risks of the private sector have been reduced, those associated with public debts have been substantially increased. Although it seems impossible to pin down the threshold level of public debt, it is clear that the financial market is increasingly concerned about public debt problems of advanced countries, and that it would be disastrous if the panic were ever triggered. Of course, this is a very unlikely scenario for the near future, but it is important to bear in mind that the risks are being transmitted from private to public sectors.

(ii) Recovery to the Pre-crisis Levels?

Another issue to be considered is how to assess the current economic states. It is widely agreed that demand conditions of major advanced countries are still weak, thereby requiring continued policy stimulus, but the perceptions about magnitudes appear to differ.

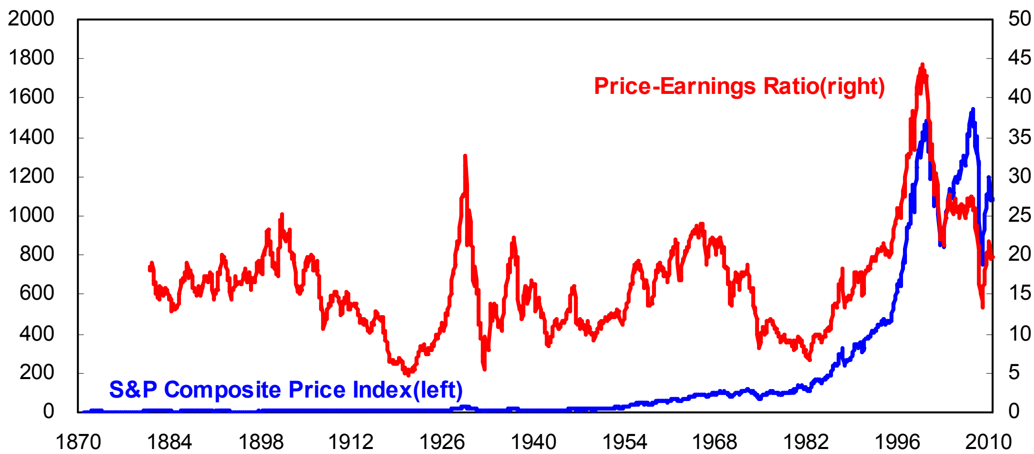
Theoretically, it would be ideal to estimate the gaps between the current and potential levels of GDP (or the current and natural rates of unemployment) in order to gauge the required policy stimulus. While such estimates are always controversial in practice, the idea itself provides an insight that the pre-crisis economic states may not be the desirable targets that we wish our economies to recover to in the near future. For example, the unemployment rate below 5% in conjunction with around 4% of economic growth in the U.S. before the crisis was regarded as signals of unsustainable overheating for several years. The U.S. stock price index has not recovered to the pre-crisis level, but the current level does not appear to be particularly low compared to its long-run trend (Figure 3). While housing markets are still weak in many advanced countries, house prices in real terms are still higher than historical average levels (Figure 4). The current recovery pace can be perceived to be “painfully slow” as the US president, Obama, described it. However, a substantial portion of this pain may be attributable to the excessive enjoyment before the crisis.

Figure 3: Real House Prices



Source: Banco de Espana(Spain), INSEE (France), Nationwide (UK), S&P/Case-Shiller Home Price Indices (USA).

Figure 4: US Stock Price and Price-Earnings Ratio



Source: http://www.econ.yale.edu/~shiller/data.htm.

(iii) Structural vs. Cyclical?

Furthermore, there is uncertainty about whether the current economic difficulties are entirely attributable to cyclical factors. Many research results (Figure 5 from Cerra and Saxna (2008), among others) show that crisis-hit countries could not completely restore their pre-crisis paths of GDP as well as pre-crisis levels of unemployment rates even after 10 years from the crises, which strongly suggests that a substantial portion of the loss in GDP and/or employment due to the recent financial crisis may be permanent (or structural) rather than temporary (or cyclical).

Figure 5: Crisis and GDP

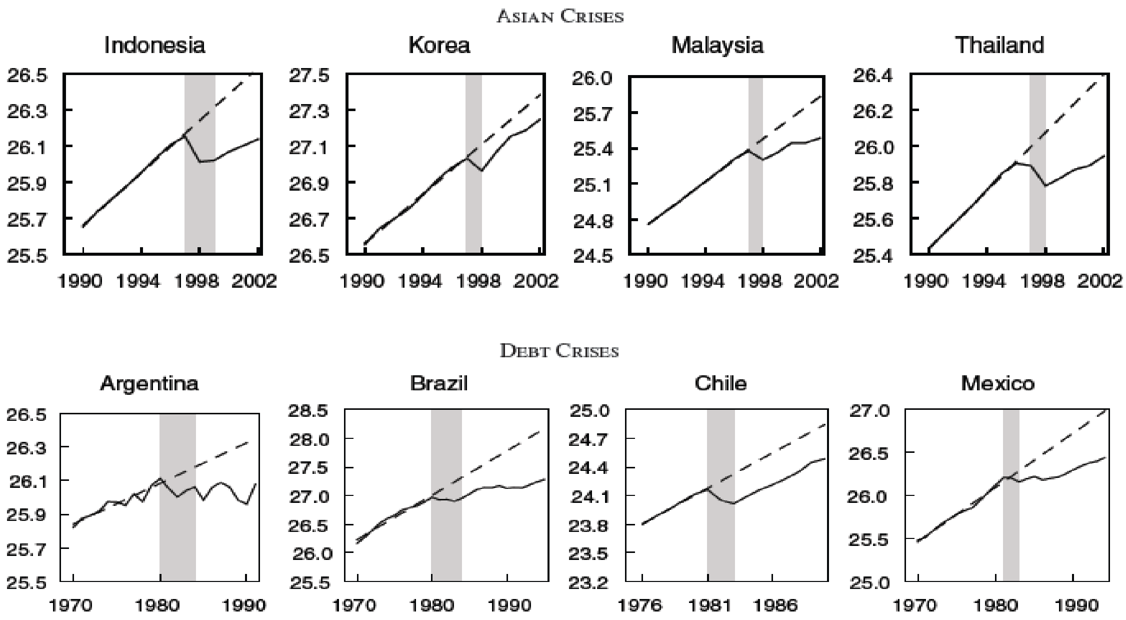


FIGURE 1

If this is the case for advanced countries, then the risk to the global economy is not just a short-term double-dip but a structurally sluggish recovery for several years. In this case, continued expansionary policy cannot be the solution: it should be dealt with by structural policies.

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3. Fiscal vs. Monetary Policy

Although the base-case scenario for the global economy is a gradual recovery, it is necessary to prepare for a downside risk. The next question is then which one among fiscal and monetary policy measures would be better to cope with risk scenarios. For this question to be properly answered, the following issues need to be considered:

(i) Which policy is more flexible?

(ii) Which policy is more sustainable?

(iii) Are there rooms for further monetary stimulation?

(i) Flexibility

It is largely agreed that monetary policy can be more flexibly adjusted than fiscal policy that should go through complicated political processes. In addition, spill-over effects on other countries' demand are more pronounced for fiscal policy than for monetary policy, whose effects can be neutralized by a resulting currency value adjustment (if the exchange rate is floated). Therefore, the more uncertain and country-specific the risks are, it would be more efficient, in general, for monetary than fiscal policy to react to unexpected high-frequency shocks.

Of course, if a shock is expected to generate a devastating outcome for a prolonged period of time (such as the shock we experienced in the fourth quarter of 2008), it would be justifiable to re-engineer the projected trajectory of fiscal policy. Particularly, if the shock paralyzes the financial market as in 2008 so that monetary policy alone cannot cope with the problem, more active pump-priming efforts from the fiscal body would be necessary. In this regard, not only the existence of downside risks but also the expected intensity of the risk scenarios needs to be discussed. At the moment, however, the probability that such a major shock is realized seems slim.

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(ii) Sustainability

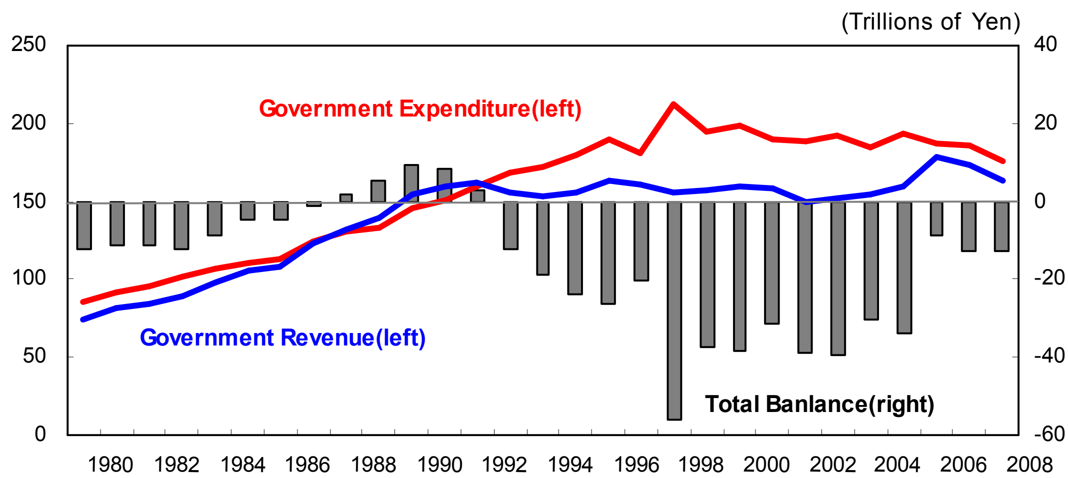
Another dimension to be considered is the sustainability of expansionary policies. As far as fiscal stimulation is defined as an increase of fiscal deficit (in percent of GDP) from the previous period, it cannot be extended indefinitely almost by definition. For many advanced countries, even maintaining the current levels of fiscal deficit (in percent of GDP) do not seem to be sustainable, considering their implications on public debt-to-GDP ratios. Although the tolerance level of public debt remains unclear both theoretically and empirically, the recent finding of Reinhart and Rogoff (2010) for advanced countries is suggestive: "median growth rates for countries with public debt over roughly 90 percent of GDP are about one percent lower than otherwise" (p.573). The implication of this finding is that it is extremely unlikely for debt-ridden countries to simply 'grow' their way out of the problem without fiscal consolidation. Currently, public debt-to-GDP ratios are already over 90 percent for some advanced countries, and are projected to reach this level within the years to come for many other countries.

In contrast, monetary expansion has no physical limit: central banks can print money indefinitely. The market cannot cast doubt about its sustainability *per se*. The associated risk of excessive money supply is the loss of paper money's attractiveness, namely inflation of prices for either goods and services or assets. But this is something that policy-makers are aiming for under the current economic situation with deflation risks. Compared to the risks associated with public debt overhang, the inflation risk is relatively easy to detect and likely to be short-lived as far as inflation targeting is credibly committed.

Furthermore, if it is unclear whether the downside risk is structural or cyclical, monetary stimulation can be less dangerous than fiscal expansion in the long run. When potential growth rates are lowered, the natural (or 'neutral') interest rates are also lowered, thereby reducing the risks associated with low interest rate policies. In contrast, if fiscal stimulation is continued in response to structural slowdown, it will only worsen the public debt problem to the extent of reduced fiscal revenues due to slow growth in the long-run.

The Japan's case is illustrative. In response to the recession in the early 1990s, fiscal spending was increased and interest rates were lowered (with hesitation). Since then, these policy stances, notwithstanding some short-term variations, have been largely maintained, while it remained unclear whether the sluggish performances stemmed from structural or cyclical factors. After 20 years, the Japanese government inherited huge debts of almost 200 percent of GDP, which was increased from approximately 50 percent in 1990. This explosive increase in public debts was not because the fiscal stimulation was ineffective in boosting the economy in the short-run (see Kuttner and Posen (2002)). It was simply because fiscal policy could not enhance long-term sustainable growth inherently and monetary policy failed to generate a reasonable rate of inflation, both of which were crucial in reducing the growth rate of fiscal revenue (Figure 6). In contrast, the damage caused by 'excessively' low interest rate policy appears to be non-existent. A lesson to learn from the Japan's monetary policy experiences would be that it needs to be sufficiently aggressive with respect to deflation risks that would be harmful not only for economic vitality but also for fiscal consolidation.

Figure 6: Japan's Fiscal Revenue, Expenditure, and Balance



Source: OECD (2010).

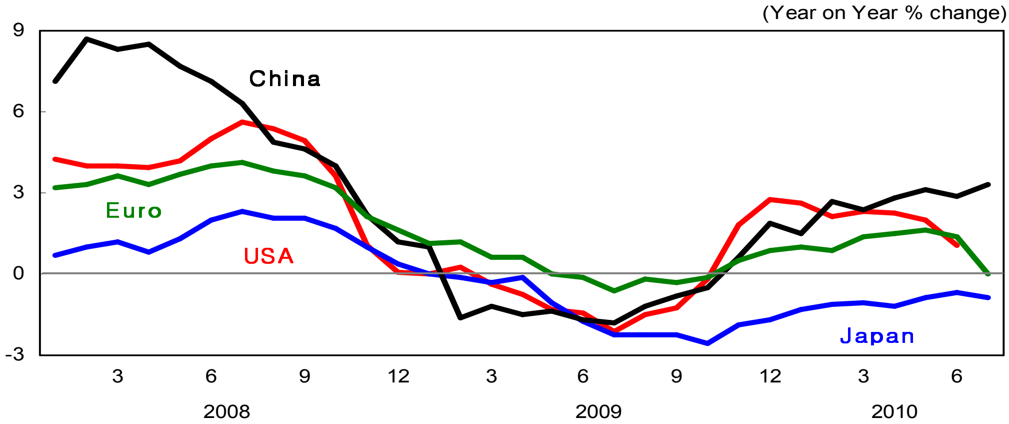
(iii) <u>Feasibility of Additional Monetary Stimulation</u>

As for monetary policy, the current concern is not its flexibility in a conventional context, but its capability to further stimulate the economy under the circumstances of near-zero target interest rates. That is, the question is whether central banks still reserve effective tools for defending the economies from possible deflationary shocks.

To this question, US Federal Reserve Chairman, Bernanke (2010), recently listed three options that the FED reserves, (1) conducting additional purchases of longer-term securities, (2) modifying the Committee's communication, and (3) reducing the interest on excess reserves, and discussed the pros and cons of each option, respectively, in his address at the Jackson Hole. These options are not completely new now, but they (particularly the first option) proved to be effective in weathering the financial market turmoil of the 4th quarter 2008. Additional and more drastic options for monetary easing can also be innovated, if the economic situation deteriorates further. For example, central banks can lower the interest rate below zero for their short-term loans to commercial banks (*i.e.*, providing subsidies for commercial banks' short-term borrowings from central banks) to encourage more aggressive investment of commercial banks.

It is not clear whether the recent economic indicators require these unorthodox policy options to be exercised. In most countries, inflation rates are getting out of last year's severe deflationary pressures and economic recoveries are progressing (Figure 7). Yet, the very recent developments differ across countries, indicating that country-specific than common forces are becoming more important, which requires more active role of monetary than fiscal policy. In any case, it is extremely important to keep convincing the market that central banks are fully committed to price stability and that they do have effective tools as well as strong wills to defend their economies from any possible deflationary shocks.

Figure 7: Inflation Rates



Source: Eurostat(Euro), Census Bureau(USA), Statistics Bureau(Japan), National Bureau of Statistics of China.

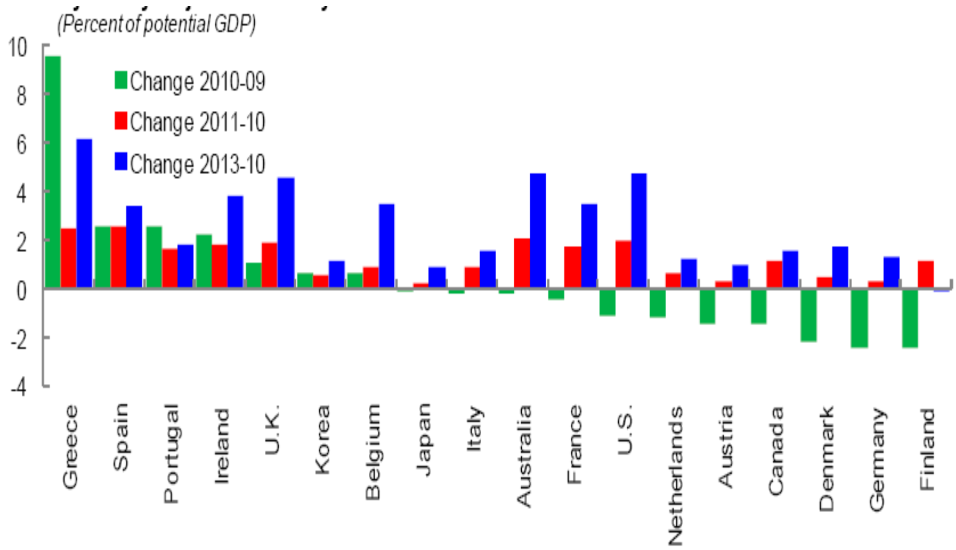
4. Summary and Recommendations

The global recovery is an ongoing process. Although its pace is bumpy and expected to moderate in the second half of 2010, the base-case scenario is still a steady recovery over the years to come, based on which the G-20 needs to design the main policy recommendations.

Yet, it is also necessary to prepare for risk scenarios. Under the current circumstances, the market will want to hear about how the G-20 perceives downside risks and what the contingency plans are. For this purpose, risk factors should be identified from various perspectives, such as (i) how likely the risk scenario is to be triggered, (ii) how severe the impacts would be, and (iii) whether the risk factors are structural or cyclical. This article argues that, under many uncertainties about the nature of risks, it would be more productive and less dangerous to have monetary than fiscal policy to flexibly respond to possible disturbances.

This background discussion leads to the recommendation that the Toronto G-20's basic stance on fiscal consolidation be carried over to the Seoul Meeting. Unless another round of global disruption is triggered, a major revision in the fiscal plan in 5 months would only damage the credibility of the G-20. As announced, each member country should submit its "growth friendly" fiscal consolidation plan, and the G-20 needs to perform the mutual assessment process. In this process, however, the G-20 can allow member country to have a limited degree of flexibility, such as the paces of fiscal adjustment to the goal in 2013 being tailored to each member country's different economic situations (Figure 8). At the same time, the G-20 can call for strong commitments of central banks to price stability so that any deflationary shocks would be actively coped with.

Figure 7: Projected Changes in Cyclically Adjusted Primary Balances



Source: IMF (2010)

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The Global Economy and Framework: Seoul's challenges

September 18 2010

Wendy Dobson

At Toronto as growth rebounded, G20 leaders agreed to a macroeconomic exit strategy, pledging to cut fiscal deficits in half by 2013 and to stabilize or reduce debt-to-GDP ratios by 2016. The G20 Mutual Assessment Process supported by the international institutions examined the global consequences of countries' domestic policies and identified opportunities for government to do things differently – and to do different things -- to contribute to more positive global outcomes.

Toronto was the easy part. At the Seoul summit Asia will be in the spotlight as the popular focus on the G20 shifts to its core task: changing the composition of demand to ensure growth is sustainable in the long term. Robust growth has resumed in the Asian economies but its composition needs to shift from reliance on external demand to greater reliance on domestic demand. The shift depends on an agenda of challenging policy changes: structural and institutional changes to encourage domestic demand, financial regulatory reforms and the successful conclusion of the global trade talks to restore market confidence.

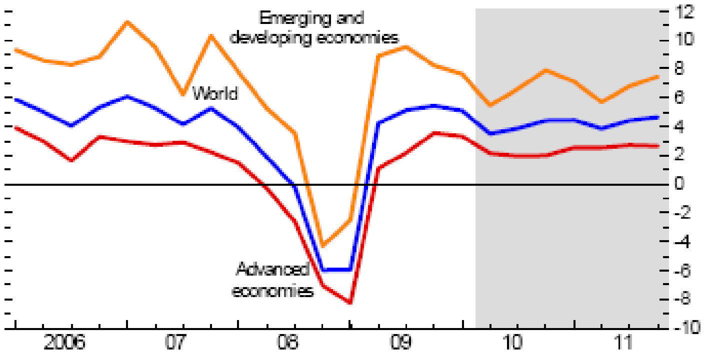
The growth outlook

Global growth increased in 2010 to an average of 4.6 percent, but it is multi-speed (Figure 1). By IMF estimates China and India are leading the world at 9-10 percent growth rates, followed by the United States which rebounded to 31/4 percent, Japan to 2 ½ percent with the euro area lagging at 1 percent. These rates are expected to moderate in 2011 to 4.3 percent, but there have been surprises after mid-year as US growth weakened while Germany surprised with a 2.2 percent growth spurt.

Figure 1: Real GDP Growth Projections (IMF, July 2010)

What should be the top policy priority for the G20 Framework exercise?

The Toronto summit formalized medium fiscal consolidation strategies, the G20's immediate challenge. The Seoul summit should shift to deliverables on the medium-term imperative of more balanced global growth. In this section I first review progress on fiscal consolidation and then move to rebalancing and structural changes in subsequent sections. 2



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Fiscal Consolidation Strategies in the Advanced Deficit Countries

In the next couple of years governments and central banks need evidence of organic growth: businesses restocking inventories; hiring rather than firing; labor market expansion that supports household income growth and consumer spending which in turn encourages businesses to invest. The evidence is still muted and so the authorities are being cautious. If stimulus is withdrawn before organic growth is re-established these economies could enter a renewed slump, even a deflationary spiral. Exit too late and precious resources are wasted and the seeds of future inflation sown. At the same time many of the large countries have little room left for further fiscal stimulus because of structural deficits and high levels of indebtedness: the IMF projects aggregate public indebtedness will be 110 percent of GDP in 2015 compared to 30 percent in emerging and developing economies.

In countries with large credit bubbles interest rates are at historic lows and central bank balance sheets are in uncharted territory. While monetary policy should not be used to reduce the real burden of public indebtedness central banks continue to rely on quantitative easing to provide stimulus.

G20 leaders' commitment to fiscal consolidation at Toronto helped to formalize exit strategies which need to be signaled well in advance to condition expectations. As the international institutions stressed in their advice to governments, these exit strategies should anticipate longer-term requirements and be 'growth-friendly'. They should take account of longer-term imperatives such as demographic shifts; thus as fiscal stimulus is removed primary balances should be improved to meet the challenges of aging populations (which implies both tax reforms and changes to entitlement spending). Governments should also shift public spending in the direction of investments that foster future growth, such as education, green infrastructure, physical infrastructure upgrading and reducing distortionary taxes. In surplus countries, shifts in spending are desirable to support households bearing the burdens of adjustments in product and labor markets in some cases and to support aging populations in others.

The exit strategies of the United States, China and Japan are of particular importance at Seoul. In the United States stimulus vs austerity is the subject of intense debate. Those arguing for more public spending emphasize that demand must be maintained by the public sector as long as private sector demand remains weak; they point to the relatively jobless recovery, rising structural unemployment (Table 1) and fiscal problems of state governments. The alternative argument emphasize that the deleveraging following a financial crisis takes a long time; that unemployment is increasingly structural unemployment because, for example, labor mobility has been reduced by the implosion of housing prices faced by those who might move. Thus reliance on more public spending will only increase public indebtedness, increase uncertainty about future taxes and inhibit businesses' investment and hiring decisions. Without a compromise, the United States lacks a credible medium-term fiscal consolidation plan. Prior to the Toronto summit President Obama publicly committed to reduce the fiscal deficit to 3 percent of GDP by 2015. But the administration's own 2011 Budget projected the deficit-to-GDP ratio will drop to 11 percent in 2010 (down from 13 percent in 2009) and decline to not more than 4 percent between 2015 and 2020 (whereas 2-3 percent is considered to be sustainable). Private sector assumptions show the deficit remaining above 5 percent of GDP in the next decade. These numbers are not sustainable.

The Administration's proposals in the 2011 budget rely mostly on expenditure compression rather than on added revenues. The imminent expiry of Bush-era tax cuts, a major factor contributing to persistent deficits, is also the subject of debate. By one argument allowing them to expire will amount to a badly-timed tax increase. The counter-argument favors expiry as a way to reduce the deficit and to raise taxes on higher-income groups. A short-term extension is a possible compromise. The economic reality is that achieving a sustainable fiscal position will require higher revenues raised in a 'growth-friendly' way, such as through tax reforms that shift the burden of taxes away from income and property towards consumption. Since no politician is willing in the current polarized political environment to advocate 3 higher taxes, the bipartisan National Commission for Fiscal Responsibility, with all expenditure and revenue items on the table, is the most promising mechanism to provide objective analysis and expert advice.

Table 1: Unemployment rates, selected economies (OECD Harmonised Unemployment Rates,

July 10 2010) Unemployment rate, 2010 Q1 (% of labor force)		**Changes in rates over the same period of the previous year** (2010 Q1 over 2009 Q1)
Euro Area	9.9	1.1
United States	9.7	1.5
Japan	4.9	0.4
Australia	5.3	0
South Korea	4.3	0.8
Mexico	5.3	0.4

China also carried out a strong fiscal stimulus program beginning in 2008. A surge in directed lending by the banking system magnified the impact of increased government spending. In 2009 China's growth performance led the world; as signs of inflation appeared in late 2009 administrative measures were used to rein in bank lending to the property markets and local governments. By mid-2010 signs of slowing activity prompted some loosening of credit for infrastructure and alternative energy investment. Exchange rate management was also eased prior to the Toronto summit as the central bank abandoned the de facto peg to the US dollar and returned to the practice begun in July 2005 of managing the exchange rate in reference to a basket of currencies.

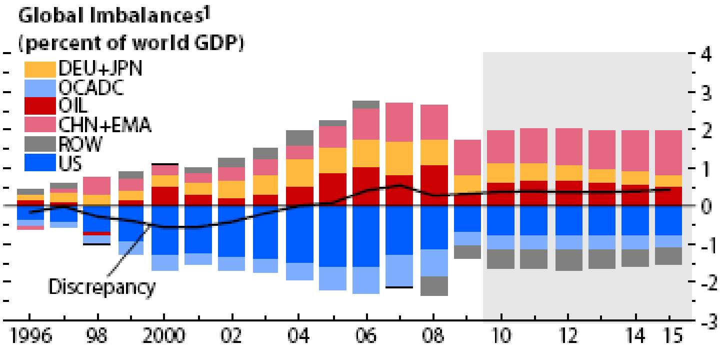
Japan, the economy most affected by the collapse of net exports in 2009, experienced a robust rebound in 2010 with growth nearly 5 percent in the first quarter and expected to average 2.4 percent for the year. As the restoration of external demand fades and fiscal policies are tightened, however, growth is expected to slow in 2011 to less than 1 percent.

While short-term macroeconomic exit and fiscal consolidation is not a particular priority in East Asian countries with prudent fiscal and monetary policies, the medium-term imperative of global rebalancing will depend their active participation in reducing reliance on export-led growth and depending more on domestic demand.

Addressing Global Imbalances

The Seoul summit must demonstrate that G20 leaders are serious about changing the composition of aggregate demand as growth returns. Global current account imbalances peaked in 2006 but the IMF expects them to rise again, as surpluses rise in East Asia with the restoration of global trade and financing 4 flows (top segment of each bar in Figure 2). To prevent their recurrence, countries with external surpluses should rely more on domestic demand and imports while those with external deficits should rely more on exports. Flexible exchange rates would help cushion the necessary adjustments.

Figure 2. Global Imbalances (IMF, April 2010)



Rebalancing will be both a technical challenge and the G20's biggest political challenge. Surplus countries in Asia resist flexible exchange rates and continue to build their foreign exchange reserves (to two segments in each bar in Figure 3). One of the lessons to draw from the disruptive market adjustments as imbalances declined in 2009 is that the process could have been smoother with flexible exchange rates. In the absence of flexible exchange rates more of the burden of adjustment must be borne by structural policies that may not be popular at home as they impact consumer and trade interests vested in the unsustainable status quo. Yet with the US consumer no longer the engine of growth a determined effort to rebalance is essential to take up the slack.

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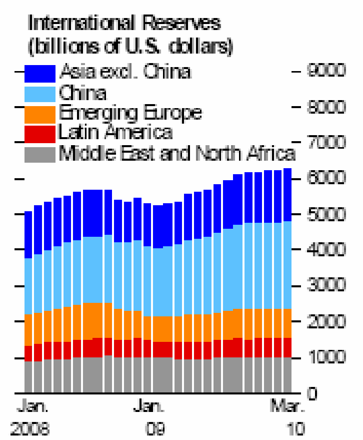
Figure 3. International Reserves (IMF WEO Update July 2010)



The IMF in cooperation with the OECD and other international organizations has shown the benefits of collective action to reduce imbalances and the risks of continuing the status quo.

In preparation for the Toronto summit the IMF prepared a base line scenario of growth and output in 2014 based on countries' own forecasts and adjustment packages. These were then adjusted for consistency and subjected to alternative assumptions reflecting upside possibilities and downside risks. Significantly the model assumes exchange rate flexibility. The differences in outcomes under the two scenarios are 5 startling. Collective action yields large benefits: world output would be higher by US$ 1.6 trillion and global growth over the next five years would be 2 1/2 percent higher than the baseline. Over 13 million jobs would be created in emerging Asia (Table 2A.)

Table 2A: Upside Scenario: Employment and Output Gains by region (IMF Mutual Assessment, June 2010)

	Employment	Unemployment 1/	Real GDP	
	(Millions)	(Percentage points)	(2009 USD billion)	(Percent)
United States	3.1	-2.0	426	3.0
Euro area 2/	4.6	-2.8	563	4.5
of which Germany	1.6	-3.8	174	5.2
Japan	0.5	-0.8	126	2.5
Emerging Asia	13.2	-0.7	128	1.4
Rest of the world	8.2	-1.1	370	2.1
World	29.5	-1.4	1614	2.5

Table 2B: Downside Scenario: Employment and Output Losses

	Employment	Unemployment 1/	Real GDP	
	(Millions)	(Percentage points)	(2009 USD billion)	(Percent)
United States	1.6	1.0	765	5.4
Euro area 2/	2.1	1.3	705	5.6
of which Germany	0.7	1.6	192	5.7
Japan	1.0	1.5	244	4.8
Emerging Asia	11.3	0.6	109	1.2
Rest of the world	6.6	0.9	301	1.7
World	22.7	0.9	2124	3.1

Notes: 1/ Unemployment for emerging Asia and rest of the world is calculated using the respective output responses and assuming the maximum estimated unemployment response in the other regions. 2/ Based on PPP-weighted average of Germany and the other euro members; employment and real GDP level is a sum of Germany and the other euro area members.

Risks in the downside scenario compared to the baseline (Table 2B) imply large losses in output and employment – 23 million jobs lost of which more than 11 million are in emerging Asia and a million in Japan —and an estimated 60 million people fall into poverty. World output will be 3.1 percent lower and unemployment nearly 1 percent higher than the baseline.

Comparison of the downside and upside scenarios provides a dramatic estimate of the global benefits of collective action. Global output would be 5.6 percentage points *higher* with policy actions (comparing Tables 2A and 2B fourth columns, bottom lines) than if the risks were to materialize. Unemployment would decline rather than rise (even in emerging Asia unemployment rises in the downside scenario).

New Sources of Growth

Key policy choices account for the difference in growth outcomes. Clearly growth-friendly fiscal consolidation in deficit countries is essential. Beyond that two kinds of structural reforms are included in the models: structural reforms that strengthen domestic demand (and replace the US consumer) and structural reforms to enhance productive potential.

Strengthening domestic demand: Countries with external surpluses are assumed to take up some of the slack in global demand by strengthening domestic demand with such measures as strengthened social safety nets with pension and health insurance programs, enhanced physical infrastructure that reduces supply bottlenecks, reformed corporate governance and more-developed financial markets that can extend credit to small and medium-sized enterprises. Household demand is assumed to expand as wage rises are permitted, restrictions loosened on labor mobility and households provided with capital income-generating opportunities. Of course the structure and timing of such reforms will depend on each country's economic circumstances and institutions.

In emerging Asia the Mutual Assessment exercise found that raising public investment in emerging Asia by 2 percent of GDP over three years increases domestic demand relative to the base case through investment projects and stronger safety nets that provide targeted transfers to the poor of around 2 percent of GDP. These expenditures are financed with higher deficits and higher consumption taxes.

Enhancing economic potential: Advanced countries with external deficits could take a number of measures that include speeding up financial regulatory reforms to reduce financial uncertainty and reforming entitlement programs. Emerging market deficit countries could simplify product market regulation and increase the efficiency of the formal sectors to encourage more employment. Other reforms include product market reforms that encourage competition in network industries, professional services and retail distribution. The OECD estimates that even moving to 'best practice' product market regulation would raise productivity growth. Labor market reforms to increase the flexibility of labor markets, particularly in Europe, would also be growth-enhancing.

These changes would both enhance and provide more balanced growth through time. Current account deficits will decline as currencies depreciate, savings rise in advanced deficit countries and external demand for their products increases while in advanced surplus countries product and labor market reforms will enhance both investment and consumption. In emerging surplus countries reduced precautionary saving and higher infrastructure spending will boost domestic demand and imports which, with currency appreciation, help reduce current account surpluses.

Financial regulatory reforms: in the advanced economies at the epicenter of the crisis is another source of future growth. To restore organic growth financial institutions must also be willing to resume lending. A troublesome aspect of the recovery is the uncertainty around financial sector reforms, both because of pushback from powerful vested interests and the need to get the reforms right. In the troubled advanced economies support for the financial sector has to be unwound, banks' bad assets removed from their balance sheets and incentives changed to make support less attractive. Risks of future instability also need to be reduced and ways found to tackle future financial crises without taxpayer support. Financial reform legislation along these lines has been adopted in the United States but global standards are still needed to prevent new regulatory distortions that will affect cross-border capital flows. The Basel institutions are working towards defining new and safer standards for capital, liquidity and leverage ratios as well as capital buffers for approval by leaders at the Seoul summit.

Safeguarding trade liberalization and completing the Doha Round: Restoring trade liberalizing momentum would also help restore confidence essential to future growth. The IMF's downside scenario paints the risks of renewed recession. Jobless growth and rising structural unemployment in the run up to US midterm elections risks renewed protectionism and political pressures to turn back globalization. Few governments have much fiscal room to maneuver in the face of still-high unemployment and rely instead on external demand. If both deficit and surplus countries pursue the same strategy the threats of protectionism will rise. The return of the US trade deficit in June 2010 to a size not seen since the crisis began reflects both weaker-than-expected growth in exports, the weaker euro and resistance by major exporters in Asia and Europe to rebalance their economic growth. Up to now G20 leaders have repeatedly charged their trade ministers with finding ways to finish the Doha round; the issues are so technical that leaders have not directly intervened. Economists Gary Hufbauer and Robert Lawrence suggest a 7 potential catalyst for restarting the talks which leaders should consider. If China were to join the WTO government procurement agreement, as it has recently indicated it will do, and help restart the services negotiations the United States and Europe should agree to grant China the market economy status in anti-dumping and countervailing duty cases that it has sought for many years. An initiative of this kind which serves both the global interest in expanding trade and key interests of large countries could be the catalyst for other countries to rejoin and conclude the talks.

Where to with the Framework Process beyond Seoul?

The Framework is still young. Setting goals and evaluating alternative scenarios are a first step. Seoul will be expected to begin delivering results. These results will depend on individual countries, particularly the largest economies; but they will also depend on involving countries beyond G20 members though such institutions as the APEC summit in Yokohama which takes place immediately after Seoul:

The United States: A credible medium-term plan of fiscal consolidation is required, no matter the outcome of the political debates about its composition. This is unlikely until after the November 2010 mid-term elections, however, when the bipartisan National Commission on Fiscal Responsibility's report comes due. All options should be on the table, including a broad-based consumption or carbon tax as well as spending cuts. Policy initiatives to increase US exports in the next five years should be consistent with the global trade liberalization agenda.

China: As a major surplus country China's relatively fixed exchange rate implies that much of the burden of rebalancing must be carried by domestic policy changes. Domestic policies are moving to encourage the growth of domestic demand but more can be done. Structural reforms in the services industries that allow more competition would raise productivity. Further fiscal reforms to extend education services, infrastructure, public pensions and health insurance to the rural areas, along with labor market reforms that raise wages will help reduce high household saving rates. Raising artificially low input prices for energy, land, the environment and capital will change incentives for industrial production. And allowing exchange rate appreciation will facilitate these shifts, either *real* appreciation through higher domestic inflation or nominal appreciation.

Other Asians: One priority which Seoul organizers have recognized is that the Asian economies need to build confidence in macroeconomic stability through closer policy cooperation that encourages greater exchange rate flexibility and reliance on CMIM, rather than further building their own reserves, to provide liquidity if they run into balance of payment problems. Surplus East

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Asian economies could contribute more to global demand by reducing export incentives, increasing domestic demand through infrastructure projects and raising productivity in services industries by encouraging competition. They could make labor and product markets more flexible and encourage household consumption by creating social safety nets and developing domestic financial markets in ways that reduce credit constraints on households and small businesses.

G20 Co-chairs Canada and South Korea have successes from which others can learn. Few realize that Canada completed a major fiscal adjustment in the mid-1990s when it moved from a deficit of 8.7 percent of GDP to a small surplus helped by public support for consolidation, a growing world economy and a flexible exchange rate. Canada is now a paragon of fiscal and monetary prudence with an effective system of financial regulation. South Korea is a graduated 8 emerging market economy which introduced major structural reforms as it recovered from the Asian financial crisis more than a decade ago. Others can learn from South Korea's strategy to reduce export dependence through domestic investments in human capital, technology and a "Green Korea" strategy of energy conservation, clean energy R&D and energy efficient transportation.

Europe: Much of the uncertainty about global growth prospects emanates from Europe, so crisis management measures are important. The European stabilization fund and unprecedented central bank intervention have bought time for countries with sovereign debt problems to restructure their finances. But serious questions remain about economic governance in the euro zone where deeper coordination is required to restore and maintain fiscal prudence. Clearly future economic growth will depend on rising productivity which in turn will require politically-difficult and long-delayed product and labor market reforms in a slow-growth environment. Germany as the large surplus economy should stimulate domestic demand to facilitate such changes.

APEC: has a major role to play. The Yokohama summit on November 13-14 is strategically important to the overall G20 agenda. Given the importance of trade to its members APEC leaders should find a catalyst to restart and complete the Doha round. They should agree to strategic goals for the APEC growth strategy and follow through with deliverables in 2011 at Honolulu.

Communicating with Markets on Seoul Outcomes

A year after Pittsburgh Seoul faces a formidable communications challenge since tangible progress is expected on new standards to make global capital markets and institutions safer; policy changes that facilitate sustainable long-term growth and forward movement to conclude Doha. A Doha deal would be a strong signal as would final agreement on Basel targets for capital, liquidity and leverage ratios, commitments to living wills, and a process that delivers structural reform.

A signal of growing G20 legitimacy would be sent if the Yokohama APEC summit builds on the Seoul decisions in the APEC growth strategy involving more countries. Structural reforms on the G20 agenda are central to the five attributes of APEC's strategy of balanced, inclusive, sustainable, innovative and secure growth. These include regulatory reforms of services sectors, the financing and provision of infrastructure that deepens APEC connectedness and advances the low carbon economy, and capital market reforms to allocate capital resources more efficiently. Serious consideration should be given to appointing a high-level task force on structural adjustment to work out a regional strategy with milestones.

Other Asian regional institutions have potentially-supportive roles to play. The ASEAN+3 Macroeconomic Research Office, a surveillance mechanism which will begin work in 2011 to support macroeconomic cooperation, could provide institutional support for rebalancing by its members. Individual governments could establish independent expert commissions on structural reforms that help persuade publics of their importance. The US National Fiscal Responsibility Commission is one example. Singapore's Economic Strategies Commission chaired by the Minister of Finance and the Malaysian government's New Economic Model are others. These mechanisms could reduce the risks of the IMF's downside scenario being the outcome should governments opt for quick fixes and declare success.

IMF Reform: Immediate Agenda and Remaining Challenges

September 18, 2010
Sungmin Kim

1. Background

The International Monetary Fund (IMF) has been a central part of the global response to the financial crisis, and this has underscored the value of the IMF as a platform for global cooperation. It is also recognized that the IMF's capacity needs to be strengthened, to enable it to better respond to future crises and thereby support strong, stable and sustainable world economic growth. For this, it is essential to improve the IMF's legitimacy, credibility and effectiveness by reforming its governance and mandate.

At the 2008 November Washington Summit, G20 Leaders "underscored that the Bretton Woods Institutions must be comprehensively reformed so that they can more adequately reflect changing economic weights in the world economy and be more responsive to future challenges." Against this backdrop, at the 2009 September Pittsburgh Summit, G20 Leaders committed to a shift in quota shares and agreed that a number of other critical governance issues needed to be addressed. At the 2010 June Toronto Summit, they then clearly reaffirmed their commitment "to strengthening the legitimacy, credibility and effectiveness of the IMF, to ensure it succeeds in carrying out its mandate." One of the key objectives of these reforms is to reflect the changes in the world economy, in view of the strong growth in dynamic emerging markets and developing countries, including the poorest.

The deadline for IMF quota reform was pushed forward from January 2013 to January 2011 at the London Summit in April 2009, and at the Toronto Summit it was pushed up further to November 2010, when the G20 Leaders "called for an acceleration of the substantial work still needed for the IMF to complete the quota reform by the Seoul Summit and in parallel deliver on other governance reforms, in line with commitments made in Pittsburgh." This indicates the urgency that these issues be resolved by the November Seoul Summit. Given that the IMF reform has quantitative targets, and that the Leaders have themselves pushed the deadline for IMF quota reform forward twice, stressing the importance of IMF quota and governance reform, this agenda is also symbolic in the sense that it determines the credibility and sustainability of the G20 process itself. At the same time, completing this task is an important steppingstone for further reforms of the IMF and the international monetary system.

In this note, I will discuss some important issues related to this urgent agenda in the lead-up to the November Seoul Summit. I will then briefly touch upon remaining challenges.

2. Reform of IMF Quotas and Governance

2.1 Reform of IMF Quotas

The Leaders have committed to "a shift in quota share to dynamic emerging market and developing countries of at least five percent from over-represented to under-represented countries using the current IMF quota formula as the basis to work from." In interpreting this language, some emphasize a shift of at least 5 percent to dynamic EMDCs, while others underline the shift from over-represented to under-represented countries. There have been many discussions on whether the current formula should be altered or not. Should the current formula be used, due to the tightness of the timetable, it has been suggested that adjustments will also have to be made outside the formula.

As for the mechanism of the shift, the distribution of quotas could be achieved via a combination of selective (distribution in proportion to calculated quotas), equiproportional (distribution in proportion to existing quotas), or ad hoc quota increases.

The size of any increase in IMF quotas has a bearing on our ability to facilitate changes in quota shares. A substantial increase in quotas may be needed to achieve a shift in quota shares and to restore quota resources relative to global GDP to the levels agreed in the general quota reviews during the 1980s and 1990s. While many members have called for at least or up to a doubling of quotas, there are also proponents of a smaller increase in quotas, suggesting an increase in quotas that will allow for a 5% quota shift to be sufficient.

G20 leaders are also concerned with protecting the voting shares of the poorest members within the IMF. At Pittsburgh, they committed to "protecting the voting share of the poorest at the IMF." The voting shares of the poorest could be protected through an ad hoc quota increase for them as a group, or as individual countries. Another option is to increase the number of basic votes. Given the tight timeframe, however, it appears realistic that protecting the voting shares of the poorest through ad-hoc quota increases would be preferable to amending the Articles of Agreement of the IMF to change the number of basic votes.

2.2 Governance Reform

The G20 Leaders agreed in Pittsburgh that critical IMF governance issues need to be addressed as part of the quota review. These issues include: (i) the size and composition of the Executive Board, (ii) IMF Governors' involvement in strategic oversight of the IMF, (iii) open, transparent and merit-based selection of the heads and senior leadership of all international financial institutions, and (iv) enhancing staff diversity.

In their September 2009 London Communiqué, the G20 Finance Ministers and Central Bank Governors stated that "the voice and representation of emerging and developing economies, including the poorest, must be significantly increased to reflect changes in the world economy." In the area of Executive Board composition, the practical implication of this seems relatively straightforward -- that the composition of the Board should be realigned in such a way as to increase the voice and representation of emerging markets and developing economies on it.

However, the implication as to the size of the Board is far from clear. Obviously, there is a trade-off between size and efficiency. At the moment, most members support maintaining the Board's current size, while some support a reduction to enhance its efficiency.

There have also been discussions on how to enhance Governors' involvement in the strategic oversight of the IMF. This can be done through (i) activation of the Ministerial Council, (ii) enhancement of the IMFC, or (iii) establishment of the International Monetary and Financial Board (IMFB), a new decision-making ministerial body.

In Toronto, Leaders agreed to strengthen the processes of selection of heads and senior leaderships of IFIs in the lead up to the Seoul Summit, in the context of broader reform. There is general support for open, transparent and merit-based selection, irrespective of nationality, of the Managing Director and other senior management staff in the IMF. As to staff diversity, the IMF has been trying to ensure that its hiring policies help to increase regional and academic diversity and recognize prior work experience. G20 members have agreed on the importance of enhancing staff diversity, and will need to review the progress made by the IMF in this regard and identify possible areas for improvement.

2.3 Strategies for IMF Quota and Governance Reform

Through discussions at all levels, each country's position has been made clear, and the options related to some issues have been identified. The next step is for members to narrow down these options and work toward concluding the discussions in the spirit of compromise and with the resolve to deliver on the Pittsburgh commitments.

Korea, as the 2010 G20 chair, is working to facilitate discussions through the G20 WG for IMF reform, in parallel with the discussions in the IMF Executive Board and the IMFC Meeting, to reach agreement on these reform issues in the order of their priority. Going forward, this will involve first narrowing down the options as much as possible at the working level, and bringing forth a final political decision within the time necessary.

2.4 Possible Timeframe

Efforts need to be first made to achieve tangible outcomes by October 9 at the IMFC meeting. Should additional subsequent discussion be needed, the G20 Sherpas could provide political impetus through the Sherpa Meeting on October 14-15, in order for final agreement to be reached at the Meeting of G20 Finance Ministers and Central Bank Governors on October 22-23.

3. Remaining Challenges

As mentioned, the above agenda is an important steppingstone toward strengthening of the legitimacy, effectiveness and credibility of the IMF. Going forward, there remain many other challenges for improving the international financial system in general and the functioning of the IMF in particular. These include more ambitious issues related to reform of the IMF's mandate, such as improving the IMF's multilateral/financial sector surveillance, reforming its lending facilities, and strengthening the stability of the International Monetary System.

Regarding strengthening of the IMF's surveillance function, the crisis has demonstrated quite clearly how the interlinked nature of the global economy as well as the financial markets can lead to a crisis in one single country developing into a global one. A crisis in a "systemically important country (SIC)", in particular, can generate serious cross-border contagion effects.

This provides strong justification for strengthening the bilateral and multilateral surveillance functions of the IMF. At the same time, given the intertwined relationship between the macro-economy and the financial system, the IMF's financial sector surveillance should also be strengthened. This would require substantial collaboration with the Financial Stability Board and other international institutions, and mutual understanding would be needed on a clear division of labor and responsibilities between these institutions. More effort at the G20 level should be devoted to determining an appropriate way forward in this regard.

Meanwhile, the effective functioning of IMF surveillance depends critically on the willingness of countries to comply with the policy recommendations made during its surveillance process. One critical question in strengthening the surveillance functions of the IMF is whether there is scope for a "too-big-to-comply" problem. Such a problem, if it were to materialize among countries deemed to be "SICs", could bring about very serious consequences to the global economy.

Although the IMF's quota and governance reform could address such a "too-big-to-comply" problem to a certain extent, it is far from a complete solution to making sure of the effective functioning of the IMF's surveillance of "SICs". More effort should therefore be devoted to exploring other measures to make the IMF's surveillance more effective and binding.

In the area of reforming the IMF's lending facilities, since the 2008 outbreak of the global financial crisis, there has been marked progress made in improving its existing lending facilities and introducing new ones. In particular, we welcome the recent decision of the IMF Executive Board to introduce a Precautionary Credit Line and to improve its Flexible Credit Line. While acknowledging the progress made so far, however, we also feel that more effort should be put into further diversifying the instruments for tackling countries' temporary liquidity problems and discouraging them from huge accumulations of international reserves for self-insurance purposes.

Finally, one further key issue in the international financial system is how to address the growing instability of the International Monetary System (IMS). One potential source of growing instability of the IMS is the fact that there are few key reserve currencies in it at the moment. One potential problem with having a small number of key reserve currencies is that occurrence of "key reserve currency crunch", a severe shortage of supply of key reserve currencies, is more likely than would otherwise be the case, as evidenced by the severe "dollar crunch" in the international financial markets during the recent crisis. Another potential problem associated with having a limited number of key reserve currencies, combined with large volumes of international reserve accumulation, is that since most of the accumulated reserves are invested in the financial markets of a few key reserve currency countries, this could possibly lead to asset price bubbles in the countries with those key reserve currencies. And to a certain extent, in fact, this contributed to generating the housing market bubble in the United States during the pre-crisis period -- by allowing the level of its long-term interest rates to remain abnormally low. In this regard, we welcome the French initiative to address this issue as chair of the G20 next year.

Note for G-20 working group on international safety nets

September 18, 2010
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The working group co-chairs ask for our views on the "ways in which the international financial architecture can be strengthened in order to better support countries who experience volatility in capital flows and foreign liquidity shortages as a result of macroeconomic and financial shocks."

To be properly addressed, this question should be put in the context of all the policies and instruments that are used by countries to insure themselves against macroeconomic shocks. Countries can insure themselves in several ways: by hedging, by accumulating international reserves, by relying on crisis lending from the IMF (or other international arrangements), or by prudential capital controls that may reduce their vulnerability to balance-of-payment crises. This broad set of policies has been called "macro-insurance" or "country insurance" (Becker et al, 2007). The microeconomic theory of insurance is indeed rich of insights that can be transposed to country insurance—although with important caveats as explained below.

We will organize our remarks around three areas:
• Self-insurance by hedging or through the accumulation of international reserves.
• Collective insurance through international liquidity arrangements.
• The possible role of capital controls.

1) Two puzzles in country insurance: insufficient hedging and excessive reliance on international reserves

As crises have revealed time and again, private and public agents seem to under-hedge against a variety of macroeconomic risks. It is important to understand the source of this failure in order to determine the appropriate policy remedies.

Insufficient hedging could be due to an inappropriate supply of hedging instruments. For example, there are no market instruments to deliver state-contingent liquidity at the domestic or international level, although such instruments are conceivable (Caballero, 2009). The hedging instruments that do exist are often relatively underdeveloped (e.g., GDP-indexed bonds, catastrophe bonds), or suffer from significant limitations (e.g., short maturities for commodity derivatives). The development of these markets might be impeded by oordination problems that prevent achieving critical mass and standardization. It has been suggested that the main role of the public sector should be to catalyze the supply of financial socially useful innovation(Caballero, 2003).

A failure of supply is only part of the story, however. Hedging also seems to be excessively low on the side of demand. Even the hedging instruments that exist, and are sometimes available in large and liquid markets, seem underused.[1] There are several reasons that demand could be excessively low. Individual economic agents might fail to internalize the systemic effect of their hedging, in which case the appropriate policy would be to encourage hedging through regulation. The externality argument, however, is not a plausible explanation for why even governments often under-hedge their risks. Other impediments could include the reputational costs of running losses on hedging positions, or the short horizon of policy-makers. One way of reducing those impediments would be for the international community to endorse—for example, through the IMF—a code of good practice for government hedging policies, and to certify those policies.

The appropriate policy response to excessively low hedging, thus, is very sensitive to the nature of the underlying market failure. From this point of view, it seems difficult to make strong policy recommendations without a well-established diagnosis of the impediments to hedging. We would suggest that the international community—perhaps through the IMF and the World Bank—make a major effort to better understand the conditions under which the public sector might foster more socially useful financial innovation.

Given the insufficient level of hedging, another way that governments can self-insure is by accumulating international reserves. One of the most important trends in international finance is the dramatic rise in international reserves in developing and emerging market countries since the beginning of the 1990s (see Figure 1). As shown by Figure 2, international reserves have increased much more than one would predict based on the two main "rules of thumb" for reserves adequacy: that reserves should cover three months of import, or one year of short-term external debt—the so-called "Greenspan-Guidotti rule". The ratio of reserves to money supply has also increased, although to a lesser extent as emphasized by Obstfeld, Shambaugh and Taylor(2008).

The buildup in international reserves of emerging markets countries has been attributed to a desire to insure against volatile capital flows.[2] Although this is certainly a plausible motive, we do not believe that it explains the bulk of the reserves accumulation, for a number of reasons.First, the trend started in the early 1990s, before the 1994-95 Mexican crisis or the 1997-98Southeast Asian crises alerted emerging market countries to the risk of volatile capital flows(Figure 1). Second, international reserves increased much more than short-term external debt,although short-term debt is a good measure of a country's vulnerability to a sudden stop incapital flows (Figure 2).[3] Third, many developing and emerging market countries have moved

[1] For example, the total open interest position on the two largest markets for oil futures, the NYMEX and the Intercontinental Exchange (ICE), amounts to less than 0.2 percent of known oil reserves (Borensztein, Jeanne and Sandri, 2009).

[2] For example, in the words of Joseph Stiglitz: "The East Asian countries that constitute the class of '97—the countries that learned lessons of instability the hard way in the crises that began in that year—have boosted their reserves in part because they want to make sure that they won't need to borrow from the IMF again. Others, who saw their neighbors suffer, came to the same conclusion—it is imperative to have enough reserves to withstand the worst of the world's economic vicissitudes" (Stiglitz, 2006, p.248).

[3] This was precisely the reason to propose the Greenspan-Guidotti rule as a substitute to the old three-months-ofimports rule after the 1994-95 Mexican crisis. The idea was to take into account the fact that the source of balance of- payments vulnerability had shifted from the current account to countries' external balances sheets. However, the Greenspan-Guidotti rule does not do a better job than the old rule at explaining the observed accumulation of reserves (Figure 2).

away from fixed exchange rates, and the fixed pegs that remain often do not need to be sustained by a large amount of reserves.[4] Fourth, the observed accumulation of reserves is difficult to explain by a cost-benefit analysis of the precautionary motive (Jeanne, 2007; Jeanne and Rancière, 2008). The countries that accumulated the most international reserves—China and other Asian countries—are those that are the least vulnerable to crises that would require the use of those reserves.[5]

An alternative explanation for reserve accumulation in developing Asia is that it is the byproduct of high saving rates or of foreign exchange interventions to keep the currency competitive (the so-called "Bretton-Woods II" view exposed by Dooley, Folkerts-Landau and Garber, 2004). Indeed, the reserves have been accumulated primarily through current account surpluses, leading to global financial imbalances.[6] Whether the main motive was insurance or not is important because this determines the likely impact of developing international liquid arrangements on global financial imbalances (see below).

2) International crisis lending arrangements are developing but this is unlikely to have a large impact on the accumulation of international reserves.

The basic welfare case for pooling reserves is simple, and essentially the same as for risk pooling in car or fire insurance. The reserves are allocated to the countries in need, allowing an efficient reduction in the total amount of reserves, which can be invested in socially more productive uses.

However, there is one important difference between classical insurance and international liquidity arrangements. The reserves are *lent*, not transferred, by the insurance arrangement to the crisis country. This has an important implication: one must ensure that lending is repaid, which generally requires the imposition of conditionality on the borrowing country. This conditionality is different from the measures that are used to limit moral hazard in car or fire insurance, which aim at reducing risk-taking *ex ante* (before the realization of the risk). In the case of crisis lending, the goal is to ensure repayment *ex post*.[7] The effectiveness of conditionality relies on providing the appropriate incentives to the borrowing country (in particular, through monitoring

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[4] For example, who would argue that China needs a large amount of reserves to defuse the risk of a speculative attack leading to a *devaluation* of its currency? However, it is mainly the risk of a speculative attack against a fixed peg, or of run on dollar deposit, that justifies maintaining a high ratio of reserves to M2.

[5] In this regard, we would suggest that the IMF request its member countries to provide a tentative cost-benefit analysis of the appropriate level of reserves held for precautionary reasons in the context of its annual article 4 consultations. The IMF would simply record each country's analysis. Presumably, comparing notes across countries and over time would generate some multilateral discipline, as it would be difficult for a country to change its criteria every year so as to justify an increasing level of reserves.

[6] An increase in international reserve holdings does not necessarily require a current account surplus: it can be financed instead by issuing long-term external debt. Such balance-sheet operations are probably a more efficient way of accumulating precautionary reserves than distorting the real exchange rate to generate a trade surplus. That it was not the preferred method is indeed one more sign that the reserves were not accumulated primarily for precautionary reasons.

[7] This idea is captured by Tirole's (2002) view of the IMF as a "delegated monitor". See Jeanne, Ostry and Zettelmeyer (2008).

and peer pressure).[8] Both aspects of international crisis lending arrangements—risk pooling and conditionality—are key to understand and analyze the recent developments in this area.

The resources of international liquidity arrangements have expanded, both at the multilateral and at the regional levels. The G20 economies agreed to triple the Fund's lending capacity to $750 billion. Asian countries have made progress toward transforming the Chiang Mai arrangement into an Asian Monetary Fund. Looking forward, a "European Monetary Fund" has been discussed as a way of dealing with government debt crises in the euro area.

Although this development could be justified as international crisis lending catching up with the higher volume of capital flows, it is paradoxical in more than one way. First, if the accumulation of reserves is already excessive at the country level, what is the benefit of bolstering international arrangements? The answer is probably (as we have argued above) that the countries that have accumulated the most reserves are not those who need them the most for precautionary reasons.

Second, the benefits of *regional* arrangements seem difficult to understand from the perspective of insurance. Since crises are more often regional than global, the gains from pooling risks would seem to occur primarily between regions, not inside regions. It may be that the purpose of such regional mechanisms is not only insuring members of the insurance pool but also preventing a country specific crisis from spreading to the rest of the region though contagion. The regional dimension here comes from the regional scale of the externality that goes through trade and financial linkages. However, IMF lending can be supplemented with regional resources (as was the case for example in the 1994-95 Mexican crisis) on a case-by-case basis and without creating a regional institution.

It is sometimes argued that a collateral benefit of enhancing international liquidity arrangements will be to mitigate global financial imbalances by reducing the developing countries' demand for international reserves. However, we would argue that this effect is unlikely to be large. First, crisis lending is not a perfect substitute for a country's own reserves, because of conditionality and of the uncertainty surrounding the access to lending in a crisis. Second, a large fraction of reserves does not seem to be accumulated for precautionary reasons—as we argued above—so that bolstering collective insurance is unlikely, per se, to significantly curb the trend of accumulation.

There are also significant developments in the area of conditionality. The IMF is reforming its conditionality, which was criticized for being intrusive and biased following the 1997-98 Southeast Asian crisis.[9] The IMF streamlined the conditionality on its lending facilities and

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[8] The evidence suggests that IMF conditionality has been effective in that regard (Jeanne and Zettelmeyer, 2001).

[9] The debates on the "excessive intrusiveness" of IMF conditionality often reflect deeper disagreements about the boundaries of national sovereignty and "droit d'ingérence". To take an extr[9]eme an example, IMF conditionality that leads to unseat a "bad" policy-maker in a crisis country will be deemed excessively intrusive by this policymaker, not necessarily by the country's citizens. This being said, the IMF is mandated by the governments of the member countries, not directly by their citizens.

created a new facility, the flexible credit line (FCL), with little *ex post* conditionality for countries with good fundamentals. The FCL was inaugurated by Mexico, with Poland and Colombia quickly following suit.

The FCL is a positive and interesting development. It has met some demand but remains to be tested in a crisis situation—no country having drawn on it so far. One benefit of the FCL is to make the access to crisis lending more assured for countries with good fundamentals. From this point of view, it would be desirable to make the conditions that countries must satisfy to qualify to the FCL more predictable too. The IMF staff reports explaining the reasons why a country has been approved for the FCL could make the general criteria underpinning this decision more explicit.[10]

Conditionality may also give us a key to understand the *raison d'être* of regional crisis lending arrangements. For example, the main purpose of an arrangement such as the Asian Monetary

3) Prudential capital controls should play an increasing role in reducing macroeconomic risks looking forward

Financial opening in emerging market countries may have benefits in decreasing the cost of equity capital and can have a positive effect on domestic investment. However, the economic gains of international financial flows seem modest for developing and emerging market economies (Gourinchas and Jeanne, 2006). Moreover, a voluminous literature surveyed by Aizenman (2004) emphasizes the risks of liberalization and the vulnerability of emerging market financial systems to capital mobility. By making borrowing on world financial markets easier, financial liberalization may strengthen market failures (moral hazard and credit constraints) that are prevalent in emerging markets. Even in the absence of market failures, emerging markets can become vulnerable to a self-fulfilling driven financial crash and capital flight when capital flows are liberalized between emerging markets and rich countries (Martin and Rey, 2006). This also raises the question whether financial integration should be encouraged at the regional level rather than at the global level and how the trade-offs between the forms of integration can best be managed (Martin 2010).

Against this background, the conventional wisdom on capital controls is evolving. Chile has a long experience with prudential capital controls on inflows and some countries have introduced such controls in the current crisis. Recent research allows us to understand better the welfare case for optimal capital controls. For example, capital controls can mitigate booms and busts in capital flows and asset prices (Jeanne and Korinek, 2010). From this point of view, controls can be viewed as one component of the new macro-prudential policy framework that has been called for since the global financial crisis. The benefits of capital controls must be waited against their costs, which are many and have justified the opposition of the IMF to their use. This opposition is however softening (Ostry et al, 2010), which we see as a positive development. Looking

[10] Another approach would be to base prequalification on quantitative criteria à la Maastricht. We would advise against it because of the need to preserve flexibility. Fund might be to develop a "regional conditionality" perceived to be more legitimate and effective than that of the IMF, and perhaps to influence IMF conditionality in the region by providing a local alternative. Looking forward, this raises the question of the respective roles of the IMF and regional arrangements in defining conditionality.

forward, the IMF should play a more active role and develop with its members a code of good practice for prudential capital controls.

Concluding points

Improving the international financial architecture requires both a strengthening of insurance mechanisms against macroeconomic risks and of policy tools to reduce the macroeconomic risks themselves. On the first point, the development of hedging instruments should be fostered by the international community, which can be a catalyst in the supply of socially useful financial innovation. International crisis lending arrangements have an important role to play, but we argued that the demand for international reserves and global financial imbalances are unlikely to be significantly affected by the strengthening of those arrangements. Finally, macroeconomic risks that take the form of destabilizing capital flows can be reduced by prudential capital controls, for which the IMF should define a code of good practice.

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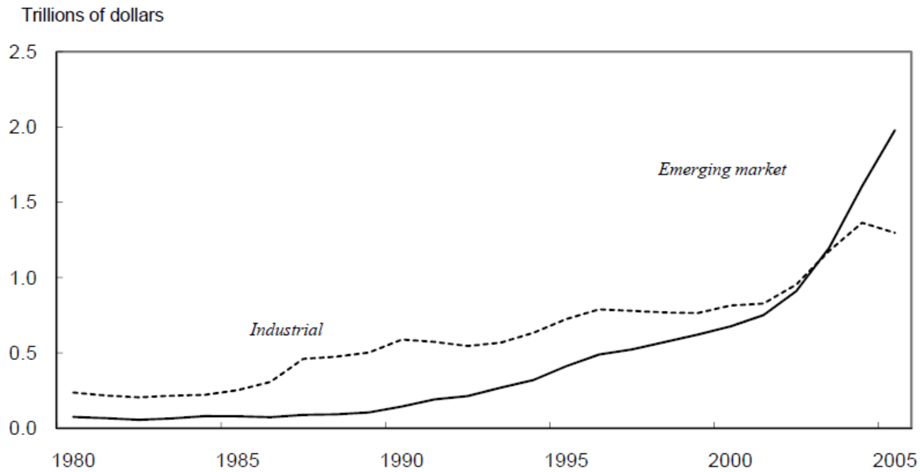
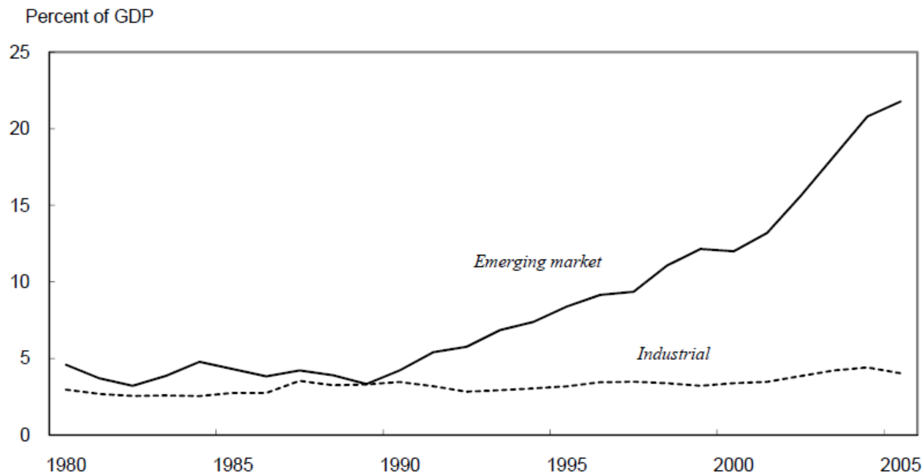
Figure 1. International Reserves in Emerging Market and Industrial Countries, 1980-2005a

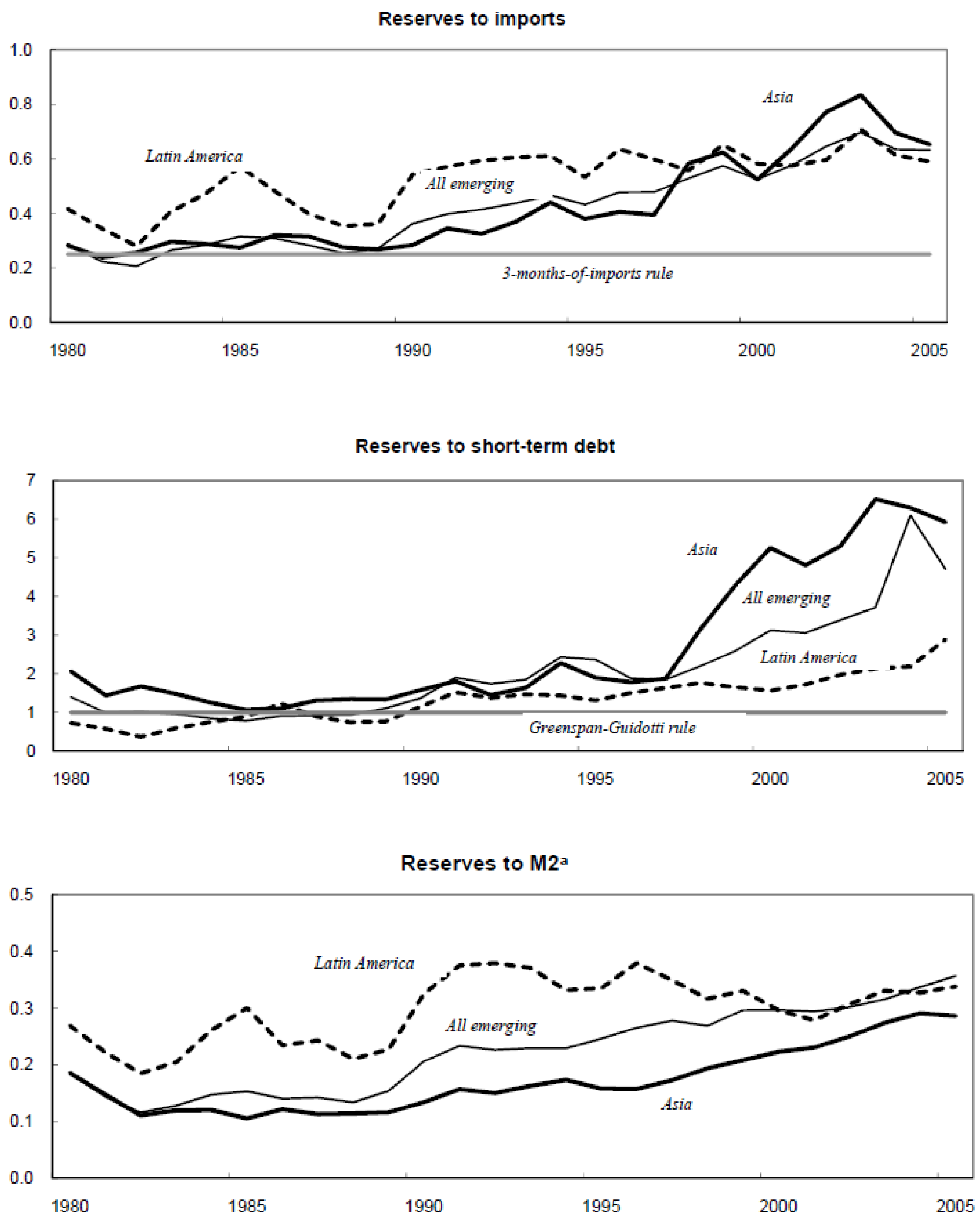


Sources: IMF, International Financial Statistics; World Bank, World Development Indicators.



a. Total reserves minus gold.

Figure 2. Reserve Adequacy Ratios in Emerging Market Countries, 1980-2005



Sources: IMF, International Financial Statistics; World Bank, Global Development Finance.
a. The conventional range of the reserves-M2 ratio is 5 to 20 percent.

Reform of Financial Regulation
A Presentation to the Korea-Canada-France G20 Seminar

September 18, 2010
Gordon Thiessen

Reform of financial regulation is a rather technical issue that would not typically be included on an agenda for a leaders' summit. However, it is important that it be part of the current summits. As time passes and the concerns about financial stability following the recent crisis start to ease, the political will to pursue the needed reforms can diminish. Moreover, in countries where the domestic financial system withstood the stresses of the recent financial crisis, there can be increasing scepticism about the benefits of participating in the reform process. We need to remember that even if our domestic institutions survived the crisis, none of us avoided the economic impact that has beset the world in the last couple of years. It is in all our interests to press for regulatory reforms on an internationally coordinated basis to reduce the risk that we will be sideswiped in the future by crises, whether they arise at home or abroad.

If we are going to complete the G20 regulatory reform agenda, the leaders must continue to deal with these technical issues at their summits and to reach agreements on them as soon as possible.

Let me begin with an assessment of where we are in the financial regulation reform process since the Toronto Summit and as preparations are made for the Seoul Summit. There are three broad areas of regulatory reform: capital and liquidity, market infrastructure, and systemically important financial institutions (the too big to fail issue).

Capital and Liquidity
The most important of the regulatory reforms is to put in place a strong capital framework for financial institutions. This involves an increase in the ratio of capital to risk-weighted assets and some revisions to the risk weights attached to certain assets. It also involves an increase in the quality of capital—that is capital that can better absorb losses. In other words, tier 1 capital should be largely common equity and retained earnings. In the Toronto Summit Declaration, the proposed capital ratio would require banks to be able to withstand stresses equivalent to those of the recent financial crisis. The leaders indicated that they wanted to reach an agreement on the capital framework at their November summit.

As I understand it, a good deal of hard work and good will has gone into achieving this deadline at the Basel Committee on Banking Supervision (BCBS). And the expectation is that the deadline will be met. While the capital framework agreement would take effect in 2011, there would in practice be phase-in periods that might vary among countries depending on their national regulatory starting points and on economic circumstances.

There was also agreement to supplement these capital requirements with the override of a maximum leverage ratio on an unweighted asset base in case the risk-weightings of some asset classes turn out to be inappropriate. The leverage ratio will be phased in with a monitoring process starting in 2011 to allow for review and calibration of the proposed ratio. A further supplement to the framework is a minimum liquidity standard. As we learned during the crisis, illiquidity can render otherwise solvent institutions unable to survive. Broad agreement has been reached in this area, but there is more progress on the minimum liquidity coverage ratio than on the stable funding ratio.

In all, good progress appears to be taking place with respect to capital and liquidity standards, the most important reform priorities. Indeed, by the time of the seminar, we should know the conclusions reached at the BCBS meeting this month. If all has gone well, that should allow for an agreement by the leaders in November. A firm agreement to implement explicit new standards would provide huge momentum to the regulatory reform process.

Market Infrastructure

Another reform area where progress seems to be taking place is in improving market infrastructure. Here the most important initiative is to identify standardized "Over the Counter" (OTC) derivatives and move them into clearing houses and, where possible, clear them through a central counterparty arrangement. And all OTC derivatives should be reported to trade repositories to make these markets more transparent. However, it is difficult to judge the full extent of the progress since much of the implementation work is of necessity being done on a country by country basis. International coordination is focused on setting standards for risk management and on capital treatment for derivatives that use central counterparties. A good deal remains to be done to put these infrastructure improvements into effect, and there are challenges in designing appropriate risk proofing arrangements. While progress in being made to meet the G20 commitment of having this infrastructure in place by 2012, an extra effort will be required to ensure that this initiative remains truly international and does not become a series of uncoordinated national arrangements.

Systemically Important Financial Institutions

The third broad area of regulatory reform, dealing with systemically important financial institutions, presents more difficulties in making progress. The issue is of course the moral hazard that arises when some institutions are regarded as being too big to fail because of their size and interconnectedness. If depositors and other creditors believe a bank would never be allowed to fail, they will be less inclined to monitor its riskiness and will be prepared to accept inappropriately low risk premiums in the interest rates they receive from the bank. This makes these large banks more competitive and willing to take more risk, and they are likely to become even more dominant. And in our highly interconnected financial world, they become more of a risk to the overall financial system.

The Toronto Summit Declaration asked the Financial Stability Board to make policy recommendations to the Seoul leaders meeting. While there was agreement that the financial sector should bear the major burden of any government intervention that may be resorted to in the future to protect the financial system from problems at systemically important institutions, there was not a consensus on how to do so. More important are policies to decrease the risk of failure of systemically important institutions and to try to make sure that problem institutions are dealt with without public funds. The leaders accepted in Toronto that different countries were pursuing varying policy approaches.

The most promising policy initiatives in this area involve converting debt-like instruments issued by banks into common equity when an institution is in difficulty. But for such measures to be effective, supervisory authorities need to have early intervention powers to take action at problem institutions before they have failed.

The BCBS has just issued a proposal for comment that would require all tier 2 capital instruments on a bank's balance sheet to have contractual terms whereby they could be written off or converted to equity when a bank was judged to be non-viable by its supervisory authority. This would be to ensure that in the event that a government does decide to inject capital into a bank for fear that winding it up would put the financial system at risk, the holders of these tier 2 instruments, such as subordinated debt, would not benefit and would still be subject to losses.

More importantly, however, the Committee is also looking at "going concern" contingent capital arrangements. In Canada, we have been promoting the concept that banks should issue bonds that would convert automatically to equity if a bank's capital ratio fell below a minimum level. This could be one part of a broader package of reform that would also allow the authorities to take control of a faltering institution and to convert various forms of bank debt and preferred shares into equity to recapitalize the bank if it was too big and interconnected to be wound up. Ideally, no public funds would be involved. Such a reform would help to diminish moral hazard by giving holders of bank debt a strong incentive to monitor a bank's risk-taking and to demand adequate risk premiums to reflect those risks.

Much work needs to be done to sort out what would be required to implement such a reform, but at least a promising avenue is being examined to deal with the too big to fail and associated moral hazard problems.

In all, there are grounds for optimism in the financial reform area. If the leaders live up to their Toronto promise to reach agreement on the major areas of capital and liquidity at the Seoul Summit, much progress will have been achieved. On the too big to fail issue, the leaders need to push the Financial Stability Board and the Basel Committee on Banking Supervision to come to a consensus on policy solutions. To announce once again that different countries are pursuing different options will risk having countries lock in those different solutions and undermine internationally coordinated reform on this issue.

I would like to turn now to some comments on a couple of issues of international financial regulation that will merit further reflection in the future.

Will the broad package of further proposed reforms permit less stringent capital and liquidity standards?

There are a number of other regulatory initiatives being considered, some more actively than others, that would add substantially to the resilience of the financial system and could provide scope in the future for lower minimum capital and liquidity requirements than are now being considered.

First of all, the BCBS is currently finalising the proposed addition of a conservation capital buffer above the minimum capital ratio. Banks with capital ratios that were not above the combined minimum ratio and conservation buffer would have limits on their ability to pay out dividends and engage in share buybacks. What this reform seeks to do is to make sure that banks retain earnings and conserve capital in difficult times, which did not always happen during the financial crisis.

A further very attractive proposal is for an additional capital buffer that would vary on a countercyclical basis. Banks would be required to build up capital in good times, which then could be run down in bad times. This would be extremely helpful in ensuring that excess capital is accumulated in times when additional credit risks are being taken on and then capital is available when some of these risks do not work out and losses are incurred, thereby protecting core capital positions. This initiative would also be useful in reducing some of the cyclical economic fluctuations now typically caused by the financial sector. These countercyclical buffers are currently being considered by the BCBS. One design issue is how automatic this process could be. Various studies have looked at metrics such as the ratio of private sector credit to GDP relative to its long-term trend to trigger a requirement for banks to build up capital buffers. This metric could also be used to release this buffer in bad times, but it does not work as well and some additional measure such as loan losses may also be considered. At least to start with, it is highly likely that accumulating and releasing capital buffers would require some degree of discretion by the authorities.

Another initiative being put in place in some countries and being considered more broadly is to set up a macroprudential authority that would monitor systemic stresses and respond to those that potentially put the financial system at risk. Systemic stresses are those that may not look all that serious for any individual bank but looked at from a macro point of view could put a highly interconnected financial system at risk. Identifying systemic risks is not all that easy or straightforward, and a good deal of work has been going on at central banks to identify early warning signals of system stress. As well, finding policy instruments to use when problems are identified is also challenging. So far, the countercyclical capital buffers linked to a rapid expansion of credit as a measure of stress, which I mentioned, have the most promising potential in this area. And it may well be that the discretionary authority to trigger the build up and run down of such buffers should be the macroprudential body set up to deal with systemic risks.

To the extent that periods of rapid expansion in the housing and mortgage markets are another potential source of systemic risk that can be readily identified, there are instruments available to the macroprudential authority such as tightening maximum mortgage loan to housing purchase price ratios and mortgage payment to borrower income ratios.

My point is that having a body charged with monitoring systemic risks, identifying potential excess risks when they arise and taking actions when needed would reduce some of the unexpected stresses on banks that minimum capital ratios are there to cover.

With respect to potentially easing minimum liquidity ratios, a possible initiative is to put in place infrastructure to ensure continuously operating markets in those funding markets that are crucial to the daily operation of the financial system. I think it is well accepted that the liquidity stresses early in the crisis that undermined confidence in financial institutions were exacerbated by funding market failures. I have already mentioned the steps being taken to move OTC derivatives into exchanges and central counterparty arrangements. Risk-proofed central counterparty structures for some crucial funding markets would lower the liquidity risks that banks would face.

If, as we look ahead, these additional regulatory initiatives were put in place and operating successfully, there should be room to lower the levels of minimum capital and liquidity requirements that are now being considered. While work at the BIS suggests that there is a high benefit-cost payoff to the new, more stringent capital and liquidity requirements, the financial industry and some of its customers are concerned about the negative impact of the increases in the cost of finance that may follow. An efficient financial industry that attracts savings and allocates credit at reasonable cost is crucial to well functioning economies. Although the recent crisis is still vivid in everyone's mind, the G20 leaders still need to be careful to strike an appropriate regulatory balance between prudence and efficiency.

Institutional Reforms

Finally, I would like to say a word about the institutional arrangements to make the new international regulatory framework operate successfully into the future.

Most importantly, we need to recognize the crucial role of the Financial Stability Board in putting together the reform package and selling it to its members. However, setting improved regulatory standards for financial institutions is not sufficient by itself. Effective supervision is also required to ensure that the standards are being adhered to. I found it interesting to see the emphasis given to supervision in the Toronto Summit Declaration, which also tasked the FSB to make recommendations to the Finance Ministers and Central Bank Governors on means to strengthen supervision.

And once the reforms are in place, there will be a need for continuous monitoring by the FSB of their effectiveness and of the extent to which supervisors in each country are implementing the reforms in a reasonably comparable fashion. If some countries are not appropriately interpreting and enforcing the agreed regulatory standards, there will be incentives for other countries to ease regulatory requirements as well to protect the international competitiveness of their banks, and the agreement will start to break down.

Perhaps the most effective instrument for the FSB to carry out these tasks is through a regular system of peer reviews. While reviews are already being done by the IMF/World Bank Financial Sector Assessment Program, they are no substitute for the real peer reviews that the FSB has started to use. But this will impose a substantial ongoing burden on the FSB. Moreover, for the FSB to be truly effective in making the financial system more robust and resilient on a global basis, it needs to increase its outreach to non-G20 countries and to formalize that process. These responsibilities for the FSB will require resources and, most crucially, ongoing support from the G20 leaders.

Ideally, what we should aim for, as we look forward, is for the FSB to become in effect a 4th pillar of the international economic and financial order along with the IMF, the World Bank (and

regional development banks) and the WTO. We should press the G20 leaders to start thinking along these lines.
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NOT ALL FINANCIAL REGULATION IS GLOBAL

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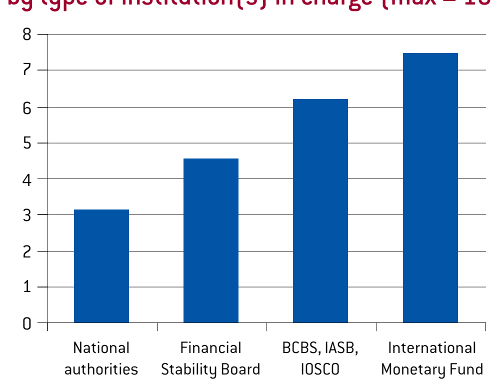
SUMMARY **The financial crisis has intensified the focus on financial regulation at global level, placing it at the top of the G20 agenda.** However, global convergence is made more difficult by **financial multipolarity**, meaning the rise of emerging economies and its impact on decision-making at global level, and **financial reregulation**, meaning the trend towards stronger regulation of financial systems to buttress financial stability, particularly in developed economies. As a result, **the ambitious objectives initially set by global leaders have so far not been turned into major international breakthroughs, and continued global capital-market integration can no longer be taken for granted.**

POLICY CHALLENGE

The global harmonisation of all aspects of financial regulation cannot be achieved. Many elements of financial stability and customer-protection policy can be determined locally. Some competitive distortions and opportunities for regulatory arbitrage will remain inevitable. But action is needed at global level to prevent damaging fragmentation of capital markets. Policy makers should prioritise four key components: (1) building stronger global public institutions, to get a comprehensive analytical picture, set authoritative standards, and foster and monitor the consistency of regulatory practice; (2) globally consistent financial information; (3) a globally integrated capital-markets infrastructure; and (4) addressing competitive distortions among global capital-market intermediaries.

Scoring of G20 financial regulation action points, by type of institution(s) in charge (max = 10)



Sum of scores on effectiveness, cross-border consistency and follow-up, sorted by leading institution in charge. See Figure 2 on page 5 for details.

AS THE SAYING GOES, 'all politics is local', but equally 'all economics is global' and regulation is one arena in which they meet and conflict[1]. This has been particularly true for financial regulation in the wake of the unprecedented financial crisis. Financial regulation has been heralded as a top priority by the newly prominent G20. But almost two years on the feeling prevails, especially in Europe, that the results have not matched the initial ambition. This warrants a reconsideration of the global financial regulatory agenda. All things being equal, consistent regulatory choices across the globe are preferable, but achieving consistency involves difficult political and economic trade-offs.

1 THE RISE OF GLOBAL FINANCIAL REGULATION

'Financial regulation' commonly indicates a cluster of interrelated policies designed to ensure the proper functioning and the integrity of the financial system, including public regulation and supervision of bank capital, leverage, liquidity and risk management; control of moral hazard and financial industry incentives; customer protection; and regulation of capital markets. Capital-flow controls, prevention of money laundering and taxation of financial activities can overlap with this agenda but are not in a strict sense about financial regulation.

Until the 1970s, financial regulation developed almost exclusively at national level. In 1974, the international ripple effects of the bankruptcy of Germany's Herstatt Bank led to the formation by the G10 Central Bank Governors[2] of the Basel Committee on Banking Supervision (BCBS) hosted by the Bank for International Settlements (BIS, established 1931). In the 1980s, as the savings and loan crisis led to tighter capital regulation in the US, American banks successfully argued that equivalent regulation should be imposed on banks in other jurisdictions, especially Japan. Thus in 1988 the BCBS produced the first Basel Capital Accord. Risk weighting under this agreement was subsequently deemed too crude to be effective, and in 2004 the BCBS produced a new accord known as Basel II.

Separately, a global financial reporting and auditing framework emerged, at first at the initiative of the private-sector accounting profession through the International Accounting Standards Committee (IASC) in 1973 and the International Federation of Accountants (IFAC) in 1977. The IASC was made independent from professional bodies in 2001 and renamed the International Accounting Standards Board (IASB). Many countries have agreed to adopt the IASB's International Financial Reporting Standards (IFRS) following the pioneering decision of the European Union in 2000-02[3].

Securities regulators coordinate at the global level through the International Organisation of Securities Commissions (IOSCO), created in 1983 from a pre-existing pan-American regional association formed in 1974. Insurance oversight is discussed within the International Association of Insurance Supervisors (IAIS), established in 1994. Public-sector audit supervisors, set up in the US and elsewhere after accounting scandals including the Enron collapse in the early 2000s, established the International Forum of Independent Audit Regulators (IFIAR) in 2006.

Beyond these sector-specific initiatives, the late-1990s emerging-market crises proved that vulnerable financial firms could cause international macroeconomic instability. In response, finance ministers and central bankers from developed and developing countries met in different forums, successively the G22 (1998), G33 (early 1999) and eventually the G20 (late 1999). Simultaneously, developed countries established the Financial Stability Forum (FSF) to enhance their coordination and foster global standards. Also in 1999, the International Monetary Fund (IMF) was tasked with assessing national regulatory and supervisory frameworks through the Financial Sector Assessment Program (FSAP)[4].

The present crisis has further enhanced the status of financial regulation from a technical issue dealt with by specialised bodies to a matter of relevance for political leaders. The G7/G8, meeting since the 1970s, tended to focus on

1. Credit is due to Michael Gadbaw for this use of the late US politician Tip O'Neill's proverbial saying on politics.

2. The G10 , established in 1962, is composed of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the UK, the US, and also Switzerland which formally joined in 1983.

3. The US is the main outlier. Japan has not made IFRS mandatory, but allows companies to use them instead of national standards.

4. This programme is jointly operated with the World Bank when applied to developing countries.

Table 1: Major crises and international financial regulatory initiatives

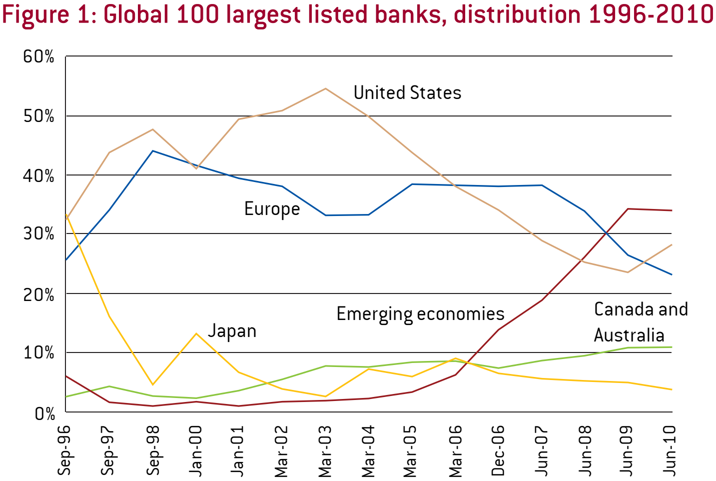
First world war/German reparations	BIS	1931
Great Depression/second world war/post-war reconstruction	IMF, World Bank, OECD	1945-48
Herstatt Bank failure	BCBS	1974
Latin-American crisis/ savings and loan crisis	Basel Capital Accord	1988
Transition in ex-communist countries	EBRD[5]	1991
Asian financial crisis	FSF, FSAP, G20	1999
Enron/various accounting scandals	IFIAR	2006
Current crisis	G20 Summits, FSB	2008-09

international macroeconomics and trade, but G20 summits since 2008 have looked extensively at financial regulation, which was the focus of no fewer than 39 out of the 47 action points in the first G20 summit declaration (November 2008). In April 2009, G20 leaders extended the FSF to major emerging economies, and renamed it the Financial Stability Board (FSB). The memberships of the BCBS and other Basel-based committees were also extended to include all G20 countries.

Because financial regulation only recently became a major international economic-policy issue, the corresponding conceptual and analytical foundation is less solid than for, say, trade and international macroeconomics, which have been topics of intense economic research and negotiation for decades.

The substantial body of literature on financial markets and intermediaries has long been only tenuously linked to mainstream economics. The impact of many regulatory questions on specific market participants has also made this policy area prone to various forms of private-sector capture. Consequently, while it has gained great prominence, financial regulation remains a comparatively immature component of international economic policy.

Figure 1: Global 100 largest listed banks, distribution 1996-2010



Distribution of aggregated market capitalisation by country of headquarters. Source: FT Global 500 rankings, authors' calculations.

2 THE NEW CONTEXT: MULTI-POLARITY AND REREGULATION

Policy outcomes will be shaped by two major shifts, which we may call financial multipolarity and reregulation. The first predates the crisis but was arguably reinforced by it, while the second is a direct consequence of the crisis.

By **financial multipolarity** we mean that the geography of global finance is rapidly evolving from a mainly North-Atlantic focus towards a much broader canvas. Notwithstanding the 1980s bubble in Japan, the joint dominance of Europe and the US in financial matters has long looked resilient, in spite of the rapid catch-up growth of emerging economies. But the centre of gravity of global finance is now moving eastward. Among the world's 100 largest listed banks by market capitalisation, the share of emerging markets has surged from almost none to more than a third, more than either Europe or the US (Figure 1). This is partly explained by the extraordinary rise in value of major Chinese banks since their initial public offerings in 2005-06. Even though their international activity remains limited for the moment, these new entrants represent a major change in the global landscape.

Looking at global financial centres rather than firms, a similar picture

5. European Bank for Reconstruction and Development.

emerges: Table 2 shows that Asian centres are hot on the heels of London and New York in the global pecking order[6]. To chase high savings and sovereign wealth, asset management teams, which a decade ago would have chosen London or New York as their obvious location, increasingly base themselves in Dubai, Hong Kong or Singapore. Over the next decade, the combination of deleveraging in the west and continued financial development in emerging economies will certainly reinforce the trend towards multipolarity, with a resulting shift of power in the global financial policy debate, even if emerging countries have been discreet in these so far. An additional factor is that the crisis has dented what previously seemed to be western intellectual leadership in financial matters.

Financial reregulation refers to the heightened concern of policymakers in developed economies about financial stability, and corresponding disillusionment about the economic benefits of unfettered finance, leading them to constrain the financial industry in new ways. For example, the July 2010 Dodd-Frank Act in the US introduced significant changes in many areas, in the face of most suggestions from the financial industry[7]. The EU has also initiated new financial legislation. In emerging economies, finance is typically more tightly regulated, and in many cases is largely or almost totally state-owned[8]. Several emerging economies may in the years to come move towards further liberalisation of their financial systems to boost credit development and growth[9]. But this is unlikely to hamper the drive towards reregulation in richer economies with high levels of financial development.

Reregulation should not be seen as a sudden, across-the-board paradigm change, but rather as a long-term trend reversal. While much financial business remained highly regulated, there was a trend towards liberalisation and reliance on market discipline during the two decades that preceded the crisis. The new trend does not mean that no financial activities will escape regulation in the years ahead, but it is nevertheless making its impact felt and is attracting solid cross-partisan political consensus in most major developed economies.

Table 2: Two league tables of global financial centres

International Financial Centres Development Index		Global Financial Centres Index	
New York	88.4	London	775
London	87.7	New York	775
Tokyo	85.6	Hong Kong	739
Hong Kong	81.0	Singapore	733
Paris	72.8	Tokyo	692
Singapore	70.1	Chicago	678
Frankfurt	64.4	Zurich	677
Shanghai	63.8	Geneva	671
Washington	61.1	Shenzhen	670
Sydney	59.5	Sydney	670

Source: Xinhua-Dow Jones IFCD Index, July 2010; Z/Yen and City of London, 7th Global Financial Centres Report, March 2010.

3 LIMITS AND PRIORITIES OF INTERNATIONAL COLLECTIVE ACTION

The consequences of financial multipolarity and reregulation may be more profound and wide-ranging than has often been acknowledged. They make global financial regulatory harmonisation a more distant prospect than was the case before the crisis. It is easier to harmonise when there is hegemony of one country or one bloc than when many diverging voices need to concur for a decision to be made. It is also easier to harmonise rules in an era of deregulation, by reaching agreement on a low common denominator, than when expectations are raised as to what the rules should achieve and these expectations differ from one jurisdiction to another.

In today's multipolar financial world, levels of financial development vary hugely. As a consequence, not only do preferences differ but governments' interest in financial regulation, and technical capacity to discuss it, are also unequal. In certain cases, authoritarianism or a fierce commitment to sovereignty may limit the scope of global agreement. By the same token, multipolarity means that

6. Unfortunately, both rankings were introduced too recently to be used to analyse mid-term trends.

7. See for example Graham Bowley and Eric Dash, 'Wall St. Faces Specter of Lost Trading Units', *The New York Times*, 6 August 2010.

8. Patrick Foulis, 'They Might Be Giants: Special Report on Banking in Emerging Markets', *The Economist*, 15 May 2010.

9. See for example, 'A Hundred Small Steps: Report of the Committee on Financial Sector Reform', headed by Raghuram Rajan, Government of India Planning Commission, 2009.

the range of regulatory issues on which developed countries can negotiate an agreement and then impose it on the rest of the world is dwindling rapidly. These limitations are likely to become increasingly visible in the next few years. In the current context, harmonisation efforts might only lead to weak global standards, necessarily complemented by tougher rules in countries with higher regulatory expectations.

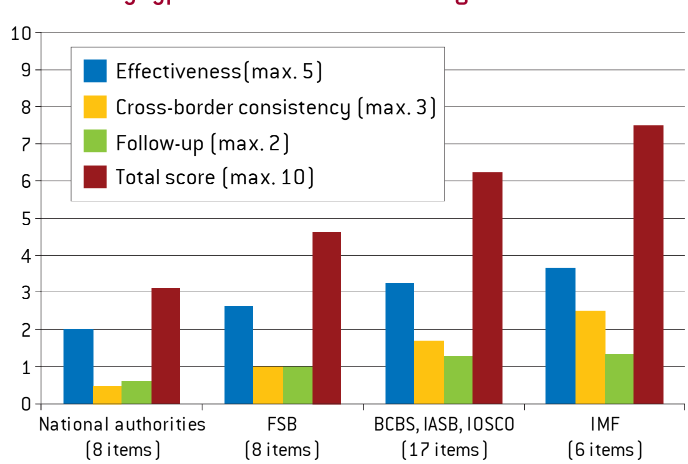
The shift to reregulation also transforms the position of several actors, especially the EU. In the previous phase, EU institutions were instinctively internationalist, as global initiatives could be effective drivers of intra-EU harmonisation. The adoption of IFRS in 2000-02 was a quintessential case. It enabled unification of accounting standards throughout the EU, where previous EU-only efforts to achieve that aim via directives had failed. But now, such dynamics are becoming unlikely as more EU-specific political objectives are fed into the regulations. This is illustrated by growing tensions between the EU and the IASB (which themselves dampen the prospects of IFRS adoption in the US), but also by other cases such as the Alternative Investment Fund Managers Directive proposals. Reregulation is making the EU more unilateralist, as the US has been for a long time.

The combination of financial multipolarity and reregulation also reduces the relative effectiveness and increases the complexity of soft coordination, which in turn gives more salience to formal, often legally grounded, processes. The high level of voluntary cooperation among central banks throughout the crisis provides a counterexample, but the unique specificities of central banking mean this cannot provide a template for regulatory policy.

Figure 2 scores the 39 financial regulation action points in the first G20 summit declaration. For each, we have graded the effectiveness of implementation, the cross-border consistency and the follow-up initiatives taken up to the time of writing. The analysis shows that the more the implementation of the action point depends on action by an international body with significant autonomy in administration and resources, the more effective the implementation.

Given the reluctance to delegate formal powers to the supranational level, accentuated by differences of financial-industry structures across jurisdictions (such as the dominance of universal banks in the EU, state-owned banks in developing countries, and differences between common-law and civil-law systems), global financial regulation will be unable to provide a seamlessly integrated, global level playing field in which all financial intermediaries can compete fairly on all markets, independently of their country of origin. From this perspective, it should not be a surprise if the eventual outcome of the 'Basel III' discussion, due in November 2010, is not deemed demanding enough to meet the reregulation requirements of several key countries (possibly including Switzerland, the UK and the US) in spite of the achievement of concluding such a complex agreement in a fairly limited timeframe. Similarly, measures to tackle the moral hazard inherent in systemically important financial institutions, on

Figure 2: Scoring of implementation of financial regulation action points in the November 2008 G20 Declaration, by type of main decision-making institution



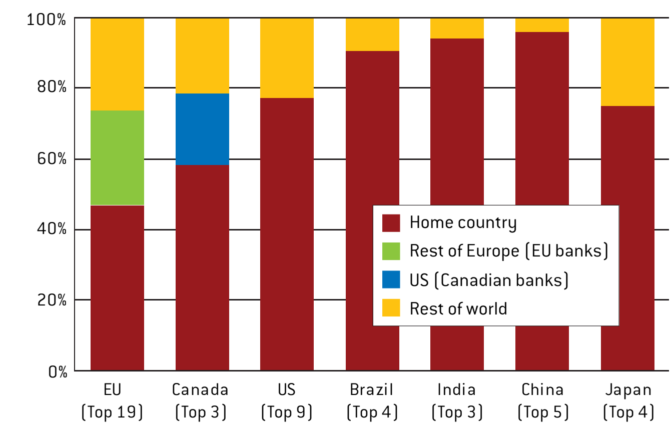
The data and methodology are detailed in Stéphane Rottier and Nicolas Véron, 'An Assessment of the G20's Initial Action Items', *Bruegel Policy Contribution* 2010/08, available on www.bruegel.org.

which the FSB is to produce a report later this year, and more generally rules that shape the structure of the financial industry, such as the 'Volcker Rule' in the US, will predominantly belong to the national (or EU) level.

Fortunately, many aspects of financial stability policy can be tackled effectively at local level, and diversity of approaches can even be beneficial. As Figure 3 illustrates, the international activity of large banks is typically less than one-quarter of the total. The main exception is the EU, where a high level of cross-border integration and the commitment to a single market call for a strong supranational supervisory framework, which is currently being discussed. But elsewhere, even multinational groups do not require internationally uniform supervision. The likes of HSBC or Santander illustrate that international synergies can arise from the leverage of technological prowess or consumer service know-how, even with locally capitalised and funded retail subsidiaries that are subject to disparate supervisory standards. As for cross-border retail branches, they are a generally disappearing species following the Icelandic experience.

However, some crucial regulatory concerns can only be addressed at global level. Without global collective action, there is a risk of fragmentation of global capital markets. The economic benefits of global financial integration for developing economies have been

Figure 3: Internationalisation of largest listed banks, selected jurisdictions

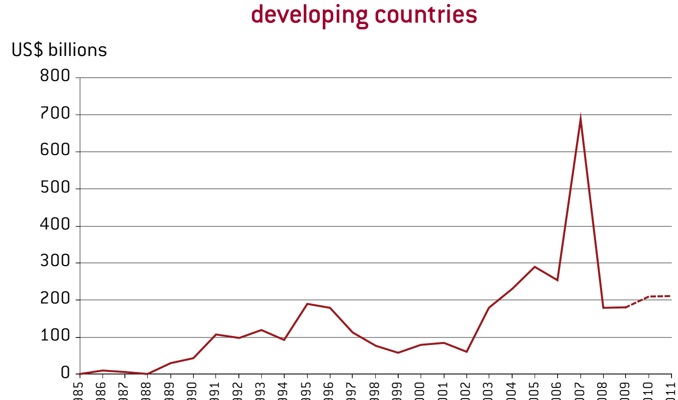


Average distribution of total 2009 revenue. Source: corporate reports; authors' calculations. Mauricio Nakahodo's research assistance is gratefully acknowledged.

questioned[10]. The Asian crisis in particular led international financial institutions to step back from advocating unlimited openness to foreign capital flows[11]. But for developed economies, and increasingly for emerging econo-mies, economists broadly agree that cross-border capital market integration has a significant positive impact on growth, by broadening the pool of investors that capital-hungry economic actors can access, and conversely by broadening the range of investment opportunities for capital providers[12].

In other terms, and with due qualification, financial integration is a global public good whose benefits may be at risk in an era of financial multipolarity and reregulation. Reregulation enhances the risk of mutually incompatible policies leading to market fragmentation, and no single power can exert sufficient leadership, benevolent or otherwise, for consistency to be ensured. The crisis itself has stalled the growth of cross-border financial flows to emerging countries, as Figure 4 shows. Available data suggest that the same is true

Figure 4: Net private financial flows to emerging and developing countries



Source: IMF World Economic Outlook database and forecasts, April 2010.

10. See for example Dani Rodrik and Arvind Subramaniam, 'Why did Financial Globalization Disappoint?', IMF *Staff Papers* 56:112-138, January 2009.

11. International Monetary Fund, 'Reaping the Benefits of Financial Globalization', discussion paper prepared by the Research Department, June 2007.

12. See William Cline, *Financial Globalization, Economic Growth, and the Crisis of 2007-09*, Peterson Institute for International Economics, May 2010, for a development of this argument and extensive literature review.

of global capital flows more generally[13].

4 A PRACTICAL AGENDA FOR GLOBAL CAPITAL MARKETS

To ensure the sustainability of financial integration, four components are essential.

The first is **stronger global public institutions**. The current environment makes this difficult to achieve, but at the same time more important as the potential for effective voluntary coordination is eroded. Global public institutions help to provide a comprehensive analytical picture, set authoritative standards, and foster and monitor consistency of regulatory practice. Policymakers should build on existing institutions wherever possible, but where suitable institutions are unavailable, they must also be ready to create new ones. The G20 has a major role to play in empowering such institutions and granting them wide acceptance, but it cannot claim to represent all countries, and is bound to fail if it tries to micromanage individual topics. The overall geography of global public bodies, whose symbolic but also practical impact cannot be overstated, should be rebalanced, perhaps by relocating one of the Bretton Woods institutions to Asia. Key pillars of a global financial body's strength include: a transparent governance framework that clearly sets out its mission, properly identifies its stakeholders, and makes it accountable to them; adequate and stable financial and human resources, avoiding funding mechanisms that could be leveraged by special interests to compromise the body's independence; sufficient access to relevant information, for which formal commitments by national or regional authorities may often be indispensible; and practice that is consistent with its proclaimed aims. Specific recommendations along these lines are outlined in the following paragraphs.

Second, **globally consistent financial information** is crucial. To start with, the IASB needs a sustainable strategy and governance model to build more trust among its stakeholders, especially investors which are the primary users of financial reporting. Instead of having each of its standards made mandatory everywhere, an overly ambitious aim in the short term, the IASB should insist on universal recognition of voluntary IFRS adoption by those issuers that desire it. It should also monitor better how IFRS are applied, in liaison with local authorities. Such measures are needed to prevent the risk of this unique experiment in global standard-setting being derailed[14].

'The level of internationally comparable information on financial systems and markets is entirely insufficient.'

Equally important is to ensure greater consistency of audits. Currently, audit firms are only regulated at national level; IFIAR does not even have a permanent secretariat. The 2002 US Sarbanes-Oxley Act attempted to grant US audit oversight authorities an extraterritorial mandate, but this has not been accepted internationally. The creation of a new global body (or a dramatic stepping-up of IFIAR's status) may be needed to underpin the global integrity of audit processes.

Public information on financial risks should be enhanced, especially for financial-sector firms. Current risk-disclosure frameworks, whether as part of IFRS or Basel II ('third pillar'), have proved insufficient, and the malfunction of credit-rating agencies in assessing structured products has compounded the problem. The publication of 'stress-test' results in the US (May 2009) and EU (July 2010) was linked to the crisis and may not be made a regular process, but regulators must find a way to bring about lasting improvement to financial risk disclosure. Additionally, the public supervision of rating agencies, which is spreading at a rapid pace[15], should be strongly coordinated at global level in order to safeguard the global consistency of rating methodologies.

At an aggregate level, the degree of internationally comparable information currently available to the public on financial systems and markets, including disclosures on government finances and their support to financial firms, is entirely insufficient. It must be increased. Governments and

13. See McKinsey Global Institute, 'Global Capital Markets: Entering a New Era', September 2009.

14. These points will be further developed in a forthcoming Bruegel publication on accounting policy.

15. Before the crisis, only the US and a few other jurisdictions such as Argentina, Mexico and South Korea formally regulated and supervised credit rating agencies. Now Australia, the EU, India and Japan have introduced regulation in this area, and several others are in the process of doing so.

supervisors should make a credible commitment to providing much more detailed, reliable and regular information, to be pooled at global level by the IMF and/or the BIS and to be made publicly available in an appropriate form.

Third, new arrangements are needed to enable and adequately supervise **globally integrated capital-market infrastructure**. The 'plumbing' that underpins markets for securities and derivatives is a big determinant of cross-border integration. Most prominently, the new trend to have over-the-counter derivatives cleared by central counterparties, or even migrated to organised trading platforms, is to be welcomed but also increases the risk of fragmentation along geographical or currency lines of markets that until now had achieved global scale. Central counterparties are systemically important and quintessentially 'too-big-to-fail' financial institutions, which raises the question of how some form of fiscal backstop could be put in place if their supervision were to be transferred to supranational level. However, this is an area where *ex-ante* burden-sharing, or a formal agreement by all or most jurisdictions concerned on how to apportion the cost of an international bail-out, is easier to envisage than in the case of banks, given the relatively straightforward nature of the activity. Therefore, global or supranational supervision may come earlier to clearing (and perhaps trading) platforms than to cross-border banks. It is also an arguably more pressing need, given these players' central role in shaping global market integration.

Fourth, **capital-market intermediaries require a global playing field**. We argued in the previous section that retail banking regulation can largely be tackled by individual jurisdictions. However, the activity of investment banks and of many non-bank capital-market intermediaries tends to be more globally integrated, which is bound to create tensions in a world in which supervision is reinforced but remains far from internationally consistent. Recovery and resolution plans, or 'living wills', are a novel idea to ensure the orderly management of failing globally integrated financial institutions, but they may increase fragmentation in the absence of an international resolution authority. Moreover, the investment banking arms of universal banks from large countries benefit from government guarantees on their home-country deposits and access to central-bank funding to an extent unavailable to competitors from small countries, which may be 'too big to save' given limited fiscal capacity at home, and to pure-play investment banks, which do not have access to such guaranteed funding. To this there is no obvious solution, and we may have to live for some time with serious competitive distortions, with players from smaller countries being placed at a structural disadvantage. More discussion is needed on these challenges. A stronger international competition-policy framework may be part of the answer in the fight against damaging economic nationalism by governments and predatory behaviour by intermediaries.

All in all, the future global financial regulatory landscape is more likely to resemble a Japanese garden, with new details and perspectives emerging at each step, than a centralised and symmetrical *jardin à la française*. Consistency will not be uniformly achieved, the boundary between global and local decision-making will remain controversial and in flux, and a spirit of experimentation and institutional entrepreneurship will be required. As political philosopher Francis Fukuyama put it in a 2005 lecture at Yale University, 'creating new institutions that will better balance the requirements of legitimacy and effectiveness will be the prime task for the coming generation'[16]. This general statement certainly applies to financial regulation.

The views expressed are those of the authors and not of their employers. The authors are grateful to all those who reviewed the draft of this policy brief.

16. Published in Francis Fukuyama, *America at the Crossroads*, Yale University Press, 2006.

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Selected Issues on International Trade

September 18, 2010
Dr. Wook Chae

I. Why is Trade Agenda Important?

☐ The multilateral trade system has operated effectively during the global economic crisis.

- Trading activities would have contracted further in the absence of WTO.
- While global trade fell by 12.5% in 2009, only about 1% of world imports were affected by new trade restricting measures.

☐ The rapid and coordinated G20 response to the rising protectionism made vital contributions to minimizing headlong contraction of global trade.

- Effective monitoring against protectionist measures through WTO.
- Successful promotion of trade financing measures and aid for trade since the G20 Summit in London.

☐ Strengthening of the multilateral trade system and promotion of free trade are essential to sustained economic growth as well as job creation.

- Trade promotes exploitation of economies of scale and specialization, helps transfer innovation, and improves consumer choice.
  - Openness of markets to competition provides powerful incentive for resource allocation towards the most productive use, raising economic efficiency and boosting incomes and economic growth.
  - Per capita real income grew more than three times faster for developing countries that lowered trade barriers (5.0% per year) than other developing countries (1.4% per year) in the 1990s (World Bank).
- Trade liberalization will lead to overall job creation, provided that appropriate economic policies are in place (OECD).
  - Globalization and openness are associated with high employment levels if accompanied by a coherent policy framework for structural as well as labor market adjustments.
  - In the short run, however, the net employment effects of trade liberalization may depend on country-specific factors such as education level and the functioning of the labor and product markets.

☐ Agenda to be discussed

- Combating protectionism
- Reviving the Doha Round Talks
- Maintaining the momentum of 'Aid for Trade'
- Response to green protectionism

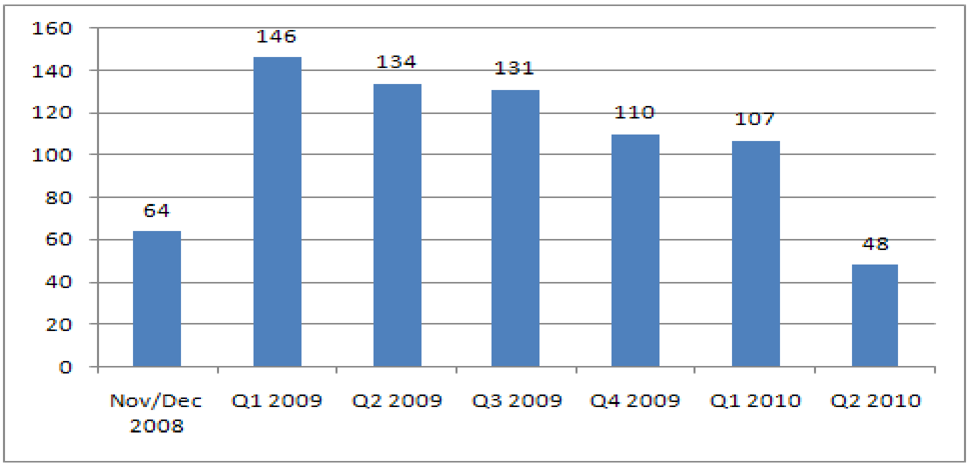
II. Combating Protectionism

<Background>

☐ The recent monitoring shows a declining trend of newly imposed measures since the outbreak of the financial crisis in 2008.

- The WTO Secretariat has calculated that new import restricting measures implemented since November 2009 cover just 0.4% of total world imports.
- Some countries imposed measures that facilitate trade, such as reduction or temporary exemption of import tariffs.
- However, new restrictions can be accumulating depending on a pace of removal of previously adopted restrictive measures.

Figure. Trend of the number of discriminatory measures newly imposed



Source: Global Trade Alert. June. 2010.

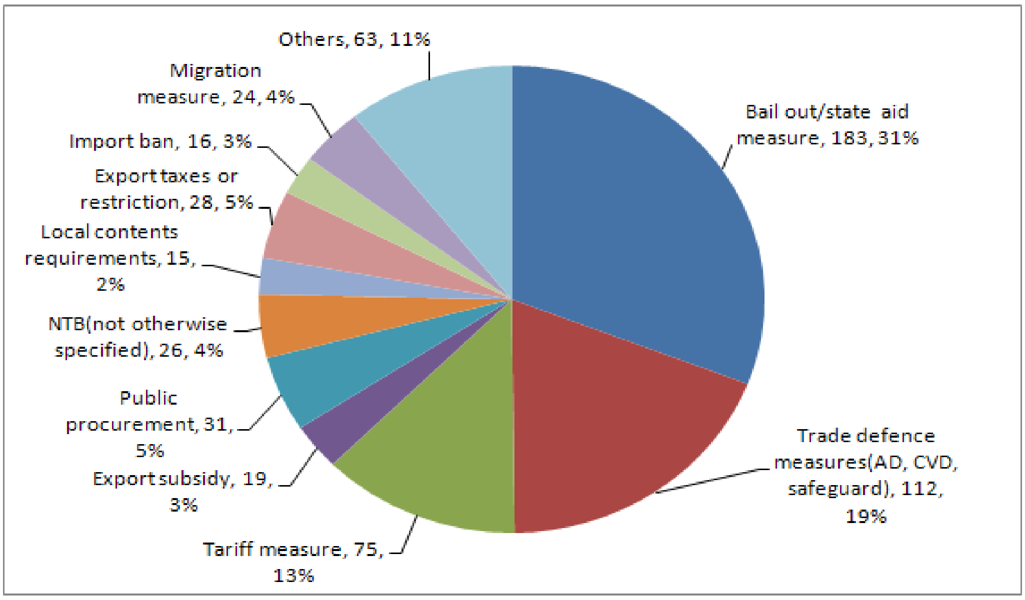
☐ The most common border measures reported to the WTO were trade remedy investigations (antidumping, countervailing and safeguard), increase in import tariffs, import bans and import license.

- The number of AD investigations raised by G-20 countries in 2009 was 21% less than in 2008 (152→193).
- Countervailing duty (8→26) and safeguard investigations (5→12) increased from 2008 to 2009.
- Some WTO member countries have also raised concerns about SPS and TBT measures.

☐ Although some countries dismantled emergency bailouts and state-aid measures, other countries have extended or expanded such programs or even introduced new schemes.

- This means that such programs could become an entrenched feature of economic policy in some countries.

Figure. Top 10 implemented measures that discriminate against foreign commercial interest since the first G-20 crisis meeting



Source: Global Trade Alert. June. 2010.

<Suggestions>

☐ Although resort to protectionist measures has muted so far, it is still necessary to establish a common understanding that the commitment to sustain strong denunciation of protectionism at the G-20 Summits will make vital contributions to the global economy which is still not free from the potential recession.

- G-20 should reinforce the commitment to resist protectionism and request countries to continue public reporting on their trade policy.
  - G-20 leaders' official commitment expires at the end of 2010.

☐ Consensus on the following needs to be reached at the Seoul G20 Summit.

- The monitoring mechanism of the WTO is still vital to prevention of additional attempts at protectionism.
- Removal of discriminatory or trade-distorting provisions from all stimulus measures.
- Restrictions on raising border measures including trade remedy investigations and increase in applied tariffs, etc.
- Transparent sharing of information concerning disguised cross-border trade barriers such as SPS and TBTs.

III. Reviving the DDA

<Background>

□ Regarding the fourth revised draft modality (agriculture, NAMA) which was distributed in December 2008, opinions nearly reached full consensus. However, in the end, due to different views about some issues such as the SSM (special safeguard mechanism), sectoral liberalization and cotton, consensus on modalities was not achieved.

□ Political impetus for completion of the DDA negotiations by the end of 2010 was generated through many summit talks and ministerial conferences held in 2009.

□ Since the second half of 2009, WTO member countries have engaged in technical negotiations on the revised draft modality in which no significant progress was made in the first half. Bilateral and plurilateral consultations have been conducted simultaneously. Efforts on the DDA negotiations have been continuing to find a breakthrough through several international conferences and a variety of negotiation methods.

- The DDA stock-taking meeting, which was held in March 2010, closed with no significant results other than WTO Director-General Pascal Lamy's statements about future negotiation methods. At the meeting, he urged adoption of a “cocktail approach” to the negotiations, which implies that negotiations would be taking place concurrently in various forms.
- The OECD Ministerial Meeting held in May established a consensus to promote a "horizontal process" which includes all negotiation coverages. The APEC Meeting of Ministers Responsible for Trade in June adopted a special statement that urged the early conclusion of the DDA negotiations.

□ The political momentum for conclusion of the DDA negotiations by the end of 2010 has been already generated. But, difference of opinions between member countries on the major issues has brought the process to a standstill: prospects for the negotiations are currently not optimistic.

- The DDA negotiations in 2010 were not moving in the favorable direction from the early stage: as a result of conflicting opinions among member countries, they failed to decide whether to hold the ministerial meeting in the first half of 2010. While Pascal Lamy, the Director-General of the WTO, suggested holding a ministerial meeting in May 2010, the US objected to the proposal, stating 'it is not yet time'.
- In addition to the DDA stock-taking meeting in March 2010, various gatherings including plurilateral negotiations, WTO Director-General Pascal Lamy's consultation, the OECD Ministerial Meeting, and the Toronto G-20 Summit were closed without any particular results concerning the progress of the DDA negotiations.

□ In the future, factors that will have major influence on the DDA negotiations will be: concentration of political power to bring about a settlement and political conditions in the major countries (the off-year election in the US in the second half of 2010, whether the Obama administration obtains the Trade Promotion Authority (TPA), the presidential election in Brazil).

<Suggestions>

☐ For the settlement of the DDA negotiations, it is necessary to make a breakthrough in the negotiation, currently stuck in impasse, as soon as possible. Since most of the major member countries at the WTO are also G-20 members, G20's efforts are critical to the settlement of the DDA negotiations.

☐ To establish a political momentum for the conclusion of the DDA negotiations, holding a senior officials meeting prior to the Seoul Summit in November is desired. And then a strong political message for the successful conclusion of the negotiations should be produced at the Summit.

- The Seoul Declaration should include an assessment of the failure as well as schedule for future action so that it can deliver a strong message for the settlement of the DDA negotiations.

☐ One way of inducing mutual concessions in the currently stalled negotiations is to find a new balance of interests among major entente.

- The key factor to the breakthrough of the negotiations is whether advanced countries such as the US and developing countries such as China and India can come to a compromise on major issues. The agreement on the modality will not be possible without mutual concessions from each other.
- A practical alternative would be to find a point of compromise by paying greater attention to the service negotiation so as to provide the advanced and developing countries with a more feasible room for the balance of interests among agriculture, NAMA and services .
- In summary, it seems inevitable to find a middle ground for a compromise through mutual concessions of the two groups: the US and other advanced countries may seek gains in sectoral liberalization and service market openings, while developing countries may seek gains in other areas such as agriculture (subsidy, SSM) and Mode 4 in service trade.

☐ Moreover, to ensure progress in the DDA negotiations, a stronger support for the least developed countries (LDCs) and other vulnerable developing economies, in overcoming difficulties they might face during trade liberalization and structural reforms, is required.

- Many developing countries have concerns that they might have to bear additional burdens, such as structural reforms, in the wake of trade liberalization under the multilateral trading system, while not fully receiving their benefits.
- To induce developing countries to participate more actively in international trade and benefit from it, it is desirable to strengthen the "aid for trade" process that renders various forms of assistance including trade-related technical support, infrastructure, and creation of productive capacity.

- The active promotion of aid for trade is certainly expected to contribute to the progress of the DDA negotiations.

IV. Maintaining the momentum of 'Aid for Trade'

<Background>

☐ Despite the gains from expansion of the global market, many low-income countries are unable to fully exploit and benefit from their access to the world market.

- Given their fundamental weaknesses (for example, various supply-side constraints, low levels of human capital, high cost of doing business, and so on) coupled with the infrastructure bottlenecks, trade liberalization and enhanced market access are not sufficient for those countries to expand trade.
- It clearly implies that an improved market access without the capacity to trade is of little use.

☐ Recognizing the importance of trade in achieving sustained economic growth, it is crucial to help developing countries build their capacity to penetrate the global market.

☐ In this regard, much attention has been paid to the potential role of aid for trade in promoting economic growth and reducing poverty in many low-income countries via expansion of trade.

- The aid for trade was designed to help developing countries overcome the barriers that constrain their ability to benefit from the existing and prospective market access opportunities that the trading system or specific countries/region offer.

☐ In the light of the commitments and actions to increase trade-related aids by members, the aid for trade initiatives have successfully raised awareness of the need to support developing countries.

- Further action is needed to enhance the effectiveness and visibility of the support and assistance provided.

<Suggestions>

☐ Establish a G20 platform to promote dialogues for cooperation between developing countries and donors.

- Encourage all key actors to honor commitments, meet local needs, improve effectiveness and reinforce mutual accountability.
- Articulate demand from partner countries as well as to address specific supply-side constraints of developing countries.

☐ Strengthen the existing mechanisms to assess the outcomes and impacts of aid for trade on trade expansion and poverty reduction.

- Improve an aid-for-trade monitoring and evaluation framework.

□ Support regional integration and corresponding activities to meet a rising demand for regional aid for trade.

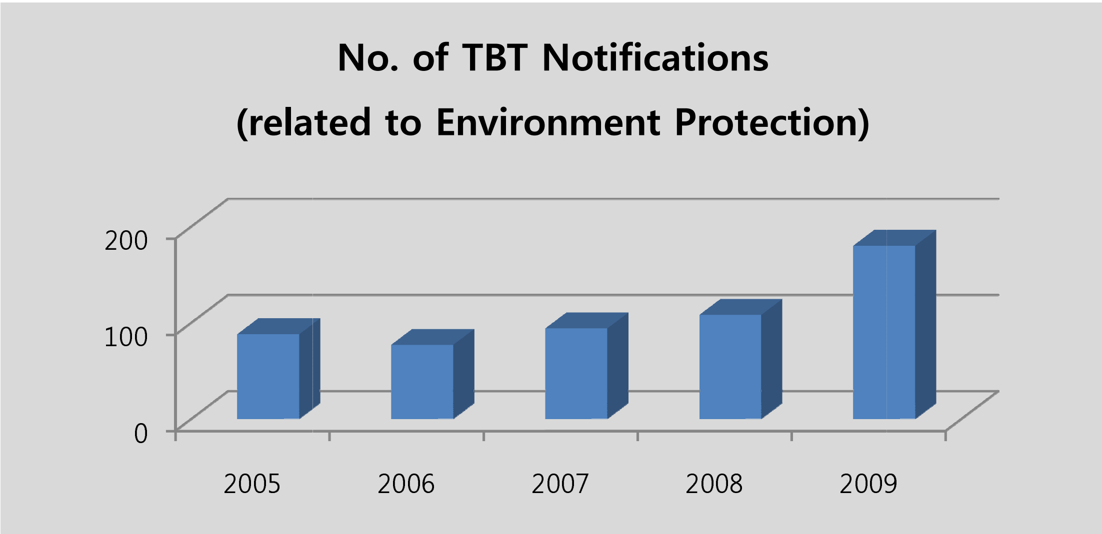
- South-South cooperation is an important element in promoting regional integration initiatives.
- Provide developing countries with incentives to ensure local ownership and accountability.

V. Response to Green Protectionism

<Background>

□ Global economic downturn and delays in the climate change negotiation are intensifying protectionist pressures and fears of green protectionism.

- The number of TBT notifications in relation to environment protection is increasing over time, especially between 2008 (108 cases) and 2009 (180 cases).



※ 2005:88, 2006:77, 2007:94, 2008:108, 2009:180
Source: Annual Review of the Implementation and Operation of the TBT Agreement, WTO

□ The result of the climate change negotiation will establish a fair burden-sharing rule which may undermine the rationale for green protectionism.

- In this respect, climate change negotiation does concern trade, and G-20 needs to pay more attention on how to complete the climate change negotiation.

Session 5: International Trade

☐ Since it will take time to complete the climate change negotiation, G20 needs to develop a mechanism to prevent green protectionism in the meantime.

<Suggestions>

☐ An effective monitoring mechanism in relation to green protectionism may be utilized to discourage the use of WTO-inconsistent measures.

- One may argue that such a mechanism would not be effective because it is not binding, but such claims have little evidence. The recent joint report from the WTO, OECD, and UNCTAD tells us that the question should be how to develop it, not whether it would work.
- The current format of monitoring reports by the WTO, OECD and UNCTAD consists simply of listing new measures.

  - It may be extended to adding analysis of new measures on whether those measures are consistent with WTO rules. And measures truly in congruence with the WTO will be highlighted.
  - Or, the report may at least classify the measures into their declared purpose as reminders.

☐ Rather than penalizing the “dirty goods,” another option can be to reward the “clean goods”.
: Since the basic motive of green protectionism is leveling the playing field, there can be another way to level the playing field in consistent with free trade. i.e, ‘promoting clean goods trade’.

- Negotiating on EG&S can be a good starting point.
- We may extend the scope of the definition of EG&S, which may be disadvantageous to developing countries. In return, we need to focus on another channel to compensate the developing countries.

  - The urgency of the risk of climate change may justify relaxing the optimal level of IPR protection so that easier access to patented clean technologies or compulsory licensing regimes can be assured.

☐ There are still remaining problems such as how to deal with green protectionism within the WTO Dispute Settlement Mechanism.

- Various approaches proposed: case-by-case approach, code approach, waiver or amendment, peace clause.
- Establish a working party within the WTO to conduct analysis on such issues.

Progressing the Trade Agenda at the Seoul Summit

September 18, 2010
Mr. John M Weekes

Session 5: International Trade
This presentation is organized under four headings corresponding to each of the questions we are asked to address in this session:

- Resisting protectionism;
- Completing the Doha Development Agenda (DDA);
- Aid for trade and trade facilitation; and
- Employment and growth.

Resisting Protectionism
So far the record of G20 members in resisting protectionism has been satisfactory but unfortunately the hard part may lie ahead. The pressure on governments is becoming greater as economic growth remains sluggish and uneven. With this continuing pressure, the need for vigilance is greater than ever. A further complication is elections in G20 countries. Citizens are tired of waiting for recovery and want results now.

According to WTO data world trade levels have recovered substantially this year but imbalances between large deficit and surplus economies have also sharpened after showing some moderation in 2009. This plus only very small appreciation of the Chinese Yuan has reignited concerns in the US Congress about the trade deficit with China and the value of its currency.

On September 9 the United Steel Workers petitioned the US Administration under Section 301 of the Trade Act of 1974 to initiate an investigation into alleged subsidies and trade barriers designed to promote China's position as an exporter of green technology. The petition requests the Administration to enforce US rights "by and through a formal request for consultations at the WTO, and, if necessary, through WTO dispute settlement". Many of the current concerns seem to have a sectoral focus and there is a danger that such concerns could spread.

Nor are such pressures confined to the United States. For instance, news reports in August suggested that the French government was considering a monitoring policy designed to ensure that a certain percentage of components used by French industry were of domestic origin.

G20 leaders in Toronto renewed to the end of 2013 their commitment to refrain from raising barriers or imposing new barriers. They also reiterated their request to the WTO, OECD and UNCTAD to continue to monitor the situation within their respective mandates, reporting publicly on these commitments on a quarterly basis.

This is one area where the G20 commitments have been effective so far and thereby contributed to the credibility of the G20. The next report monitoring developments will be available on November 1. The commitment to resist protectionism is critical in the overall context of the G20's efforts. Backsliding here could have immediate negative consequences for the key objective of the G20 to ensure a full return to growth.

We are asked in this seminar to consider whether there is any additional contribution the G20 can make for resisting protectionism. I offer two broad comments and one procedural suggestion. First, this is a leaders' commitment. It should be kept fresh so that there can be no doubt that the each leader meant what he, or she, said. Second, finishing the Doha Round would send an excellent signal that the WTO system is resilient and up to the test.

Procedurally perhaps some sort of consultation process could be envisaged in the event of any perceived backsliding. The leaders might wish to consider publicly envisaging the possibility that a G20 government could initiate a consultation with another G20 government, if it was concerned by actions taken by that government. Any such consultation could perhaps be undertaken at the level of Sherpas. Obviously recourse to consultative procedures already exists in the WTO but a G20 process would be designed to put such a consultation directly in the context of the commitment made by G20 leaders.

Completing the Doha Development Agenda (DDA)
In Toronto G20 leaders said:

We therefore reiterate our support for bringing the WTO Doha Development Round to a balanced and ambitious conclusion as soon as possible, consistent with its mandate and based on the progress already made. We direct our representatives, using all negotiating avenues, to pursue this objective, and to report on progress at our next meeting in Seoul, where we will discuss the status of the negotiations and the way forward.

This commitment was clearly not perceived as a strong one by the media and led to such headlines as "Death Knell for Doha?" How to accomplish the task set out above in a short time frame is a difficult challenge, particularly in advance of elections this fall in certain G20 member countries. This analysis first looks at the challenge from a political perspective and then at the situation on the ground in Geneva.

Political Perspective
The keys to bringing the Round to a successful conclusion lie within the G20 membership. Many now believe that a necessary precondition for completing the Round is a meeting of minds between the United States and China – in the same way that in the Uruguay Round a final deal was not possible until the United States and the European Communities had resolved their differences. If the United States and China were able to establish a basis for addressing their respective bilateral concerns in the context of the conclusion of the Round, it is very likely that that would signal the beginning of a final endgame negotiation in which the remaining concerns of other members could be rapidly addressed. (In an article entitled "Let's do a Doha deal" published over the summer, Gary Hufbauer Robert Lawrence have set out one approach for how such an accommodation might be achieved. There could well be others.)

The subject matter of the DDA is highly technical and does not lend itself to high level political discussions. However, in the end a political accommodation needs to be reached, one which all leaders can sell at home as being a reasonable deal. If G20 leaders really want an agreement, they need to give their negotiating teams the necessary flexibility to explore how to put a package together. The ground had been extensively prepared; the issues are well known; the potential solutions are obvious to the senior negotiators. The problem is that there is not yet a meeting of minds as to what constitutes "a balanced and ambitious conclusion".

Timing is critical. Most observers think that it would be very difficult to make a deal now in advance of elections in Brazil and the United States. After the election the situation may well be different. The Seoul Summit may occur at the unique moment when a narrow window of opportunity opens in which there will be broad political interest among G20 members in really trying to reach a deal. Until November China, India and Brazil are not going to be prepared to enter an endgame scenario because they don't believe that the United States is ready to deal.

If G20 leaders want to seize that moment they should be prepared to acknowledge, at least tacitly, that there are going to need to be some adjustments to the 2008 package. There is no point in having Presidents and Prime Ministers review the details of what is on the table. However, the message given by President Obama to his colleagues in Toronto, that the United States needs more than just cosmetic changes, needs to be taken on board. Leaders need to be prepared to commit to taking account of the concerns of each other and to instruct their negotiators look for ways to accommodate the various interests. What sort of discussion in Seoul might lead to that result? Based on the experience gained in Toronto an unscripted discussion among leaders might be most useful. In every G20 country there will be some adverse domestic political reaction to the likely outcome of the DDA. It would be very valuable if leaders could exchange views on their respective situations and answer the following key question. **Is each leader ready for the domestic debate on the DDA results? More precisely is each leader ready to seek and if necessary fight for the legislative implementation of the result?**

An answer from leaders in the affirmative would change the tone and content of the negotiations. Simply reiterating an intention to finish will carry no weight.

If leaders are not prepared to address this question they should start considering exit strategies that will do the least damage to the WTO and to world trade. That would be very difficult.

The task is urgent because there are a whole series of new issues and challenges that need to be addressed in the field of international trade relations. Some of these were identified by ministers at the WTO Ministerial Conference in Geneva last December, although it was clear that it was thought politically incorrect to go too far down the road of new business before the Doha Round was completed. These new issues will be addressed; the question is where and how. If these issues are not addressed in the WTO, then that institution will be further weakened as questions about its relevance become more insistent. In this context it is worth recalling the following excerpt from the concluding remarks of the Chair of the Ministerial Conference Chilean Trade Minister Andrés Velasco:

Numerous comments were made on other current and future issues facing the WTO. Climate change was raised by many. The contribution the WTO can make through removing barriers to trade in environmental goods and services was widely endorsed. There were also warnings against "green protectionism". Food security and energy security were also highlighted. Concern was also voiced about the effect of private *standards on trade, especially for developing countries. Other items suggested for consideration included government procurement, competition and investment, though reservations were also expressed.*

There was broad agreement that the WTO must remain credible in the face of emerging challenges. There were calls for deepening the WTO's relationship with other relevant international organizations, while respecting the WTO's mandates.

It was widely acknowledged that the importance of the WTO extends beyond the Round. It was also noted that finishing the Round - a stimulus package with limited fiscal cost - is vital in order to ensure that the WTO remains relevant.

On the Ground in Geneva

Spurred on by the Toronto Summit G20 heads of mission in Geneva have begun a work program in Geneva to prepare for the Seoul Summit. Director-General Pascal Lamy and senior negotiators are well aware that they will need to prepare a “report on progress” they have achieved “using all negotiating avenues”.

Lamy described the process in the following terms in his report to the Trade Negotiations Committee on July 27:

Since the March Stocktaking the Geneva process has been working according to the “cocktail” approach that the membership endorsed at that time. This process, and its ingredients — smaller groups in variable geometry, bilateral contacts and my own consultations — have been working more intensively and with purpose.

Following the summer break the negotiating process restarts this week. The most promising new avenue seems to be a plan of action by the “Group of Five” – U.S., EU, China, India and Brazil to organize small group discussion at head of mission level across all areas of the DDA. In July such groups were struck for fisheries subsidies and development issues. We understand from first hand reports that these discussions were constructive and without the recrimination and point scoring that has bedeviled most such efforts in the past.

The Group of Five are coordinating the initiation of the small group process. One group is being set up for each negotiating group with two additional groups, one for LDC issues and two groups, rather than one, for the rules area(one for fisheries subsidies and one for the other rules issues). Insiders seem fairly optimistic about the dynamic in this process and for once Lamy seems enthusiastic about a process involving ambassadors. This process has the added advantage of being below the radar screen. This means that possible options for putting a deal together may be explored without attracting adverse political comment in various domestic constituencies. It is entirely possible that options for how to bring the Round to a conclusion might be developed before the Seoul Summit.

Many G20 members will be leery of taking decisions in advance of the fall’s elections. Major players like China, India and Brazil are not going to be prepared to enter an endgame scenario until they believe that the United States is ready to deal. And the United States itself does not want to be confronted with the need to make public decisions before the midterm elections are over.

Session 5: International Trade

It is possible that the Geneva process will have produced some scenarios that would facilitate discussions by leaders and put more direct relevance into the question as to whether they are prepared to seek and if necessary fight for the legislative implementation of the result.

Aid for Trade and Trade Facilitation
We are asked to consider what the G20 can contribute to maintaining the momentum of aid for trade and trade facilitation?

Efforts in both of these areas will make a valuable contribution to the development of world trade. Progress here will make the outcome of the DDA more valuable particularly for poorer developing countries but also for also for businesses engaged in international trade. This is not a case of needing to engineer a breakthrough but of making sure that powerful positive synergies can be realized.

Aid for trade will allow poorer countries to benefit from existing trade opening in addition to that which will result from the DDA. It is about helping them build up their capacity to trade. Trade facilitation an integral part of the Round itself is a win/win for all. Success in making both happen will increase the prospects of getting a Doha deal and reinforce the benefits it will bring.

The G20 should continue to emphasize the importance it attaches to aid for trade. Donor contributions to the aid for trade project are rising but more money is still needed. In the context of a successful outcome to the DDA perhaps more funds could be committed.

The WTO is managing aid for trade well. It has not as some had feared overstepped its role. It is working well with OECD on collecting info on contributions and coordinating with the development banks

Canada has devoted considerable resources to aid for trade and has established "sustainable economic development" as one of three pillars in the priorities of the Canadian International Development Agency.

For the G20 aid for trade should remain a priority. Dropping the ball could carry negative consequences for the DDA.

Trade facilitation is a big win/win for all. Poorer developing countries need the capacity to benefit from trade. Big international companies see the benefits it would bring in facilitating customs procedures, and in reducing corruption.

The costs of implementing what is contemplated in WTO draft agreement on trade facilitation are modest. In the negotiating activity it will be important to move from self-diagnosis process to develop concrete action plans at the country level on how to make the necessary changes. It has been estimated that it would cost only $30-50 million to fund development of these action plans.

It should be recalled that there is a link in the draft trade facilitation agreement, and in the negotiating mandate, between the acceptance of obligations by developing countries and the assistance needed to implement those obligations. The G20 could take the lead in proposing that assistance for such changes be done at the outset. Efforts here will help build and maintain support for the Round among poorer countries.

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Employment and Growth
The Toronto Declaration contains a paragraph under the heading "Fighting Protectionism and Promoting Trade and Investment" which identifies the role of trade liberalization in "supporting growth and job creation, and in achieving our goals under the G-20 Framework for Strong, Sustainable and Balanced Growth". Leaders asked the OECD, the ILO, World Bank, and the WTO to report on the benefits of trade liberalization for employment and growth at the Seoul Summit.
Against this backdrop we are asked to consider two questions:

Which elements should be addressed to analyze the relation trade has to employment and growth; and

What are considerable policy implications?

I am offering no initial views on these questions which might more appropriately discussed once input is received from the four international organizations.

Korea-Canada-France
G20 Seminar

17-18 September 2010, Lotte Hotel Seoul, Republic of Korea

Biographical Note

BIOGRAPHICAL NOTES

Korean Delegation

Co-Chair

Prof. Yung Chul Park is a distinguished professor in the Department of International Studies at Korea University. Prior to his current post, Dr. Park spent three years (2005 to 2008) at Seoul National University's Graduate School of International Studies as a research professor and Director of the Center of International Commerce and Finance. He previously served as a member of the Central Bank of Korea's Monetary Board (1984 to 1986), as the President of the Korea Development Institute (1986 to 1987), as the chief economic adviser to the President of the Republic of Korea (1987 to 1988), and as the President of the Korea Institute of Finance (1992 to 1998). He also worked for the International Monetary Fund (IMF) from 1967 to 1974. Dr. Park has written and edited several books, including *China, Asia, and the New World Economy* (Oxford University Press, 2008).

Presenters, Discussants and Moderators

Prof. Taeho Bark teaches international commerce at the Graduate School of International Studies (GSIS) of Seoul National University. Currently he serves as Dean of the GSIS, a board member of the Korea Foundation as well as a member of the FTA Domestic Policy Council. Until the end of June this year, Dr. Bark has been Chairman of the Korea International Trade Commission. Dr. Bark received his BA from Seoul National University and a PhD in economics from the University of Wisconsin-Madison and taught at Georgetown University. He worked as a senior research fellow of the Korea Development Institute (KDI) and served as the Vice President of the Korea Institute for International Economic Policy (KIEP). He also worked on the international commerce issues as a senior economist in the Office of the President of the Republic of Korea. During 2000-2002, Dr. Bark served as Chair of the Investment Expert Group (IEG) of Asia-Pacific Economic Cooperation (APEC). Recently, he taught at the Jackson School of International Studies at University of Washington and at the Asia- Pacific Research Center (APARC) of Stanford University as a visiting professor. In addition, he was a visiting scholar at the IMF and consulted for the World Bank. At Seoul National University, he served as Dean for International Affairs as well as Director of the Institute for International Studies. He has written a few books and many articles on international trade, foreign direct investment and the Korean economy. Professor Bark is an economist with many applied experiences.

Dr. Wook Chae was named President of the Korea Institute for International Economic Policy (KIEP) in May 2008. He is currently a member of the Presidential Council on National Competitiveness. He has also been a member of the Policy Advisory Committee of the Ministry of Foreign Affairs and Trade; a member of the Trade Policy Advisory Committee of the Trade Minister's Office, Ministry of Foreign Affairs and Trade; Commissioner of Korea

Pacific Economic Cooperation (KOPECE); Vice-President of KIEP; and a member of the Presidential Advisory Commission on Policy Planning. Having received a Ph.D. in Economics from the University of Michigan, Dr. Chae has published numerous articles and books, including *Principles of International Economics* (Pakyoungsa, co-authored in Korean).

Dr. Dongchul Cho is a professor at the KDI School of Public Policy and Management. His major areas of interest include macroeconomics and international finance. From 2008 to 2010, he also served as a member of Presidential Council of Future and Vision. From 2005 to 2006, Dr. Cho was the senior counselor to the Deputy Prime Minister and head of the Macro Policy Advisory Team at the Ministry of Finance and Economy. He also served as a member of the Policy Advisory Committee for the Prime Minister in 2004 and the Presidency Undertaking Advisory Committee in 2003. Before he joined the KDI in 1995, Dr. Cho was a professor of Economics at Texas A&M University in the United States. He graduated from Seoul National University and holds a Ph.D. in Economics from the University of Wisconsin-Madison.
cs from the University of Paris.

Prof. Yoon Je Cho is currently a professor of the Graduate School of International Studies of Sogang University. His previous positions include Economic Advisor to the President of the Republic of Korea(2003-2005), Korea's Ambassador to the UK(2005-2008), Vice President of the Korea Institute of Public Finance(1995-1996), and Senior Counselor to the Deputy Prime Minister and Minister of Finance and Economy(1995, 1996-1997). He worked at the World Bank and the International Monetary Fund (IMF) for about ten years before he returned to Korea in 1993. He also taught at Georgetown University as an Adjunct Professor. Professor Cho received his B.A. in economics from Seoul National University and Ph.D. in economics from Stanford University. Professor Cho has published widely in the areas of the financial sector reform and restructuring, and Korea's economic development.

Dr. Sungmin Kim currently serves as Director General of the G20 Affairs Office at the Bank of Korea. He has previously worked in the Research Department, the International Department, and the Monetary Policy Department of the Bank of Korea. Dr. Kim also worked at the Central Asia Department of the International Monetary Fund (IMF) in the early 1990s and subsequently was appointed as an advisor to the IMF's Monetary Affairs and Exchange Department on various occasions between 1998 and 2005, to provide technical assistance to other central banks, in countries such as China and the Philippines. Dr. Kim has written numerous papers and books on monetary policy, corporate finance, and financial markets.

Dr. Wonhyuk Lim is Director of Policy Research at the Center for International Development, Korea Development Institute (KDI). He is also a member of the Advisory Council for the Korea Economic Institute (KEI) in Washington, DC. He has been at the KDI since 1996 and providing policy advice on the reform of Korea's family-based business groups (*chaebol*) and state-owned enterprises. He has also written extensively on development issues and inter-Korean relations. After the 2002 Election in Korea, Dr. Lim worked for the Presidential Transition Committee and for the Presidential Committee on

Northeast Asia. He was a CNAPS Fellow for 2005-06 at Brookings and worked as a consultant for the World Bank. He received a B.A.S. in Physics and History and a Ph.D. in Economics from Stanford University.

Dr. Jong Goo Yi has served as a Commissioner of Korea's Financial Services Commission (FSC) since March, 2008. He is currently in charge of international affairs at the FSC and has been acting as the Korea's representative at the Steering Committee of the Financial Stability Board since its inception in June, 2009.
Prior to joining the FSC, he practiced law at major law firms, including Sullivan & Cromwell and Shearman & Sterling in New York and Shin & Kim in Korea, specializing in finance and M&A. He also served as an adjunct professor at the Graduate School of International Studies of both Korea University and Yonsei University, teaching M&A and international financial law.
Dr. Yi acted as a vice chairman of the Banking, Finance and Securities Committee of the Inter-Pacific Bar Association and a member of the Council for Financial Development under the Ministry of Finance and Economy.
Dr. Yi graduated from Stanford Law School in 1990 with a J.D. and Stanford University in 1991 with a doctorate in Economics.

Dr. Soogil Young is President of the National Strategy Institute (NSI), an independent Seoul-based think tank on Korea's reform agenda for long-term economic development, and concurrently serves as member of the Presidential Commission on Green Growth; Chairman of the Korean National Committee for Pacific Economic Cooperation (KOPEC); Chairman of the Green Investment Forum Korea; and Vice-Chair of the Seoul Financial Forum. For twenty years after earning his Ph.D. in Economics from Johns Hopkins University, Dr. Young worked as a senior fellow at the Korea Development Institute (KDI) and as President of Korea Institute for International Economic Policy (KIEP). He served as Korea's Ambassador to the OECD from 1998 to 2000.

Special Guests

Mr. Ho-young Ahn is Deputy Minister for Trade, MOFAT and Ambassador at Large for G-20. He received BA in political science at the Seoul National University and MS in international relations in Walsh School of Foreign Service of Georgetown University. Later, he studied law at the Korea National Open University and the Georgetown University Law School. After his studies, the deputy minister joined the Ministry of Foreign Affairs and Trade and worked on international legal and economic issues. From 1993 to 1996, he worked as Director, Treaties Division II and as Director, International Trade Division III, MOFAT. From 1996, he was assigned to Korea's Permanent Mission to the OECD where he negotiated the terms of Korea's accession to the OECD. Subsequently, he worked as Korean representative to the Trade Committee, Export Credit Group and the MAI(Multilateral Agreement on Investment negotiations at the OECD.
In 1999, he was assigned to Korea's Permanent Mission to the WTO and then in 2002 became the Director for International Trade Law Division. Subsequently, he worked as

Director-General, Multilateral Trade Bureau, MOFAT and as Director-General, Economic Cooperation Bureau, Ministry of Finance and Economy. From March, 2008, Mr. Ahn was appointed as Deputy Minister for Trade. In that regard, he used to work as Korean President's Sherpa for the G-20 Summit for the first three summit meetings and continues to work on G-20 issues as Ambassador at Large for G-20.

Dr. Byung-il Choi is the Dean of the Graduate School of International Studies (GSIS), Ewha Womans University. He is leading a group of experts in the KSP (Knowledge Sharing Program) for the government of Indonesia in the field of trade and investment. Prior to joining the Ewha GSIS as a founding faculty, he was the Korean chief negotiator for the historic WTO basic telecom negotiations (1994-1997) and a key figure to institutionalize the APEC Telecom Ministerial Meeting in 1995. During 2007-2008, Dr. Choi led the Korea Association of Negotiation Studies as President. He received Outstanding Service Award from the UNA-ROK on the UN Day in 2008. His current research is on the new global economic governance, focusing on link between finance, trade and development, and the architecture of East Asia regionalism. His book, the Success and Failure of Trade Negotiations of Korea (2004), won the Korean Academy of Arts and Sciences Award. He received B.A. from Seoul National University with magna cum laude and Ph.D. economics from Yale.

Dr. Oh-Seok Hyun, a Korean national, is currently President of the Korea Development Institute (KDI), a leading think tank of Korea. He is a member of the Presidential Council on National Competitiveness, Presidential Committee on Green Growth, Presidential Committee on Regional Development, Advisory Council on Presidential Committee for G-20 Summit and Prime Minister's International Development Cooperation Committee. Dr. Hyun also served as Chairman of NPSO (the Non-governmental Public Serving Organization) Evaluation Board for the Ministry of Strategy and Finance. He has been President of the Institute for International Trade of the Korea International Trade Association.

Dr. Hyun has extensive experience in policy making and research in the public sector, a unique career path for a government official in Korea. He formerly served as Deputy Minister of the Ministry of Finance and Economy and Special Advisor to Deputy Prime Minister and Minister of Finance and Economy. He contributed in formulating and coordinating the national agenda, working as Secretary for Economic Affairs of the Office of the President and Director-General of the National Economic Advisory Council. He also served as Director-General of Bureau of Economic Policy and Bureau of Treasury of the Ministry of Finance and Economy.
Dr. Hyun successfully managed the administration of the ASEM III (Third Asia Europe Meeting) in Seoul as Executive Director. He also worked as an economist at the World Bank and served as Dean of the National Tax College. He also served as a professor at the Korea Advanced Institute of Science and Technology (KAIST). He has a Ph.D. in Economics from the University of Pennsylvania.

Prof. In June Kim is a distinguished professor of economics at Seoul National University. Dr. Kim received his BA in economics from Dartmouth College and a PhD in economics from Harvard University. From 1994 to 1998, he served as a member of the Central Bank of Korea's Monetary Board, from 2001 to 2002 as Chairman of the Money and Finance Association of Korea, and from 2002 to 2004 as Dean of the College of Social Sciences at Seoul National University. From 2005 to 2008, he was the Chairman of the Steering Committee of the Korea Investment Corporation. Dr. Kim recently served as President of the Korean Economic Association from 2009 to 2010. He has written many books especially on international finance and has been a leading scholar in his field.

Prof. Sang-kee Min is a Professor of International Finance at Seoul National University and Chairman of the Public Funds Oversight Committee. Dr. Min has been a leading scholar in the field of finance and had been presidents of a few scholarly associations including Korean Association of Money and Finance and Korean Association of Futures and Option. From 1980s, professor Min has been actively involved in the formulation of government policies. For 16 years he had been a member of "Committee for Development of Financial Industry" at the Ministry of Finance. He was the president of the Committee for the last 3 years ending 2004. Between 1996 and 1997, he served as a commissioner of the Securities Exchange Commission. Professor Min currently serves as Chairman of the Public Funds Oversight Committee. The committee is charged of provision of government funds to troubled financial institutions, relief of toxic assets and privatization of the previously nationalized firms.

Prof. Yeongseop Rhee is a professor at the Graduate School of International Studies, Seoul National University, Korea. He was a research fellow at the Korea Development Institute (KDI), a visiting research fellow at the IBER of UC Berkeley and the SSI of the University of Tokyo, a professor of economics at the Sookmyung University, and a non-resident fellow of the Brookings Institution. He has also served as a member of Financial Development Review Committee (Ministry of Finance and Economy), Advisory Group for the Korea-US FTA (Ministry of Foreign Affairs and Trade), Political Party Committee (Korea National Election Commission), and many others. He received his BA and MA in economics at the Seoul National University and his MA in statistics and Ph.D. in economics at the University of California, Berkeley. He has written many books and articles on international economics, international finance, regional monetary and financial cooperation in East Asia, Asian currency crises, and the North Korean economy.

Mr. Je-Yoon Shin

Mr. Je-Yoon Shin was appointed Deputy Minister for International Affairs of the Ministry of Strategy and Finance in March 2008. He has been participating in G20 Finance Deputy Ministers' Meetings and this year, in particular, he holds the chairmanship. He has been playing a key role in regional cooperation schemes including ASEAN+3, and his dedication and efforts culminated in the establishment of the Chiang Mai Initiative among ASEAN+3 countries. Previously, as Director General for the International Finance Bureau (2007 to 2008), he was in charge of monitoring and managing exchange rates, advancing domestic foreign exchange systems, and ensuring stability in financial markets in the aftermath of the sub-prime mortgage crisis. He was also the chief financial sector delegate for the Korea-US FTA negotiations.

Canadian Delegation

Co-Chair

Mr. Derek H. Burney was Canadian Ambassador to the United States (1989 to 1993) and served as Chief of Staff to the Prime Minister (March 1987 to January 1989). Mr. Burney was directly involved in the negotiation of the Canada-U.S. Free Trade Agreement. He was the Prime Minister's personal representative (Sherpa) in the preparations for the Houston (1990), London (1991), and Munich (1992) G7 Economic Summits. After a distinguished career in the foreign service, he served as CEO of Bell Canada International and CAE Inc. He is currently Senior Strategic Advisor at Ogilvy Renault LLP, Senior Research Fellow at the Canadian Defence and Foreign Affairs Institute (CDFAI), and Senior Distinguished Fellow at the Norman Paterson School of International Affairs (NPSIA), Carleton University. He is also Chair of the Selection Committee for the "Canada Excellence Research Chairs" programme of the Government of Canada. From October 2007 to February 2008, Mr. Burney served on the Independent Panel on Canada's Future Role in Afghanistan, appointed by Prime Minister Stephen Harper.

Presenters, Discussants and Moderators

Mr. Thomas Paul d'Aquino is an entrepreneur, lawyer, author, educator and strategist. He is Chairman and Chief Executive of Intercounsel Ltd, a private company engaged in providing strategic solutions and in advancing transformational change. He is also Senior Counsel at Gowlings, Canada's largest law firm, and chairs the firm's Business Strategy and Public Policy Group. His principal areas of practice are finance, international trade, energy and the environment.

Mr. d'Aquino serves on the Board of Directors of Manulife Financial Corporation, CGI Group Inc., and Coril Holdings Ltd. and is Chairman of the National Gallery of Canada Foundation.

He is associated with two of Canada's leading academic institutions: as Distinguished Visiting Professor, Global Business and Public Policy Strategies at Carleton University's Norman Paterson School of International Affairs; and as Honorary Professor at The University of Western Ontario's Richard Ivey School of Business. Earlier in his career, he served as Special Assistant to the Prime Minister of Canada and as Adjunct Professor of Law at the University of Ottawa lecturing on the law of international trade and global business transactions.

From 1981 to 2009, Mr. d'Aquino was Chief Executive and President of the Canadian Council of Chief Executives (CCCE), an organization composed of the chief executives of 150 of the country's leading enterprises and pre-eminent entrepreneurs. Mr. d'Aquino assumed leadership of the Council in its formative stages. Upon his retirement from the CCCE as of December 31, 2009, member companies accounted for $850 billion in annual revenues and $4.5 trillion in assets. With a combined Canadian stock market value of $675 billion, the companies are responsible for the majority of Canada's private sector exports, investment and training. In recognition of his exemplary leadership, he was named by the Canadian Council of Chief Executives Board of Directors, a Distinguished Life Time Member.

Mr. d'Aquino's has played an influential role in shaping the direction of fiscal, taxation, trade, energy, environmental, competitiveness and corporate governance policies in Canada. In the international arena, he has been a leading thinker and activist on a wide range of North American and global issues embracing international finance, competitiveness, trade, energy and the environment. One of the private sector architects of the Canada-United States free trade initiative and of the North American Free Trade Agreement, he currently is helping to spearhead private sector initiatives aimed at defining a new era in Canada-United States relations and is active in negotiations aimed at deepening Canadian relations with China, India, Japan and the European Union. In March 2010, he chaired and addressed a Leaders' Symposium in Toronto on the future role of the G20.

A native of Nelson, British Columbia, Mr. d'Aquino was educated at the Universities of British Columbia, Queen's and London (University College and the London School of Economics). He holds B.A., LL.B., and LL.M. degrees, and an Honorary Degree of Doctor of Laws from Queen's University and from Wilfrid Laurier University.

Mr. d'Aquino has been referred to as Canada's most influential policy strategist and the country's leading global business ambassador. He is the author of numerous publications including the influential book *Northern Edge: How Canadian Can Triumph in the Global Economy*. He is a regular commentator on radio and television, and a frequent speaker on platforms in Canada, the United States, Europe, Asia and Latin America. Mr. d'Aquino has addressed audiences in forty countries and in over one hundred cities worldwide.

Dr. Wendy Dobson is Professor and Director at the Institute for International Business, Rotman School of Management, University of Toronto. She is a former Associate Deputy Minister of Finance in Ottawa and has served as President of the C.D. Howe Institute, Canada's leading independent economic think tank. Dr. Dobson is a non-executive director of several public companies engaged in international business, and participates in several international research and policy networks. Her research focuses on international economics and international business. She has published numerous monographs and articles on international economics and international business. Her work on international economic integration includes a prize-winning volume entitled Multinationals and East Asian Integration (1997). Dr. Dobson's latest book, Gravity Shift: How Asia's New Economic Powerhouses Will Shape the Twenty-First Century, was published in October 14, 2009. Ms. Dobson received a Ph.D. in Economics from Princeton University.

Mr. Peter Harder is Senior Policy Advisor to Fraser Milner Casgrain LLP. Peter possesses a wealth of expertise in public policy as a result of his involvement at the centre of government decision making for over thirty years. Prior to joining FMC, Peter was a long serving Deputy Minister in the Government of Canada. First appointed a Deputy Minister in 1991, he served as the most senior public servant in a number of federal departments including Treasury Board, Solicitor General, Citizenship and Immigration, Industry and Foreign Affairs and

International Trade. At Foreign Affairs, Peter assumed the responsibilities of the Personal Representative of the Prime Minister to three G8 Summits (Sea Island, Gleneagles and St. Petersburg). In 2000, the Governor General presented Peter with the Prime Minister's Outstanding Achievement Award for public service leadership. In 2002, Peter was awarded the Queen Elizabeth II Jubilee Medal for public service. And in 2007, the President of Colombia named Peter grand master of the Order of San Carlos for his contribution to international relations. Peter has joined the Boards of Power Financial Corporation, IGM Financial Corporation, ARISE Technologies, Telesat Canada, Energizer Resources, Northland Power and Pinetree Capital Limited. Peter is also a member of a Board of Governors of the University of Ottawa, The United Church Foundation, The Commonwealth Games Foundation of Canada, Canada World Youth, chairs The National Police Services Advisory Council (RCMP) and Genome Canada. Since 2008, he also serves as an independent advisor to the Auditor General of Canada. Mr. Harder was appointed a Trudeau Foundation Mentor for 2009-2010. He also serves as the Chair of the National Arts Centre's Governance, Nominating, and Ethics Committee. In 2008, Peter was elected the President of the Canada China Business Council (CCBC).

Hon. Barbara McDougall is the Chairman of the International Development Research Centre. She is also an advisor at Aird & Berlis, counseling clients on matters of international business development, corporate governance and government relations.

Barbara McDougall was a Member of Parliament for nine years and held several cabinet posts, including: Finance (Minister of State), Privatization, Employment and Immigration, and finally External Affairs. She is a graduate of the University of Toronto, a Chartered Financial Analyst and has an honorary doctorate from St. Lawrence University.

Mrs. McDougall is widely recognized for her expertise in international relations and is frequently invited by the media to comment on current events. Her extensive knowledge and interest in international policy have led her to sit as a Canadian representative to the Inter-American Dialogue in Washington and The International Crisis Group in Brussels. She recently completed a term as the Canadian representative on the International Advisory Board for the Council on Foreign Relations in New York. She is also a director of the Institute for Research on Public Policy in Montreal, the Canadian American Business Council and the North South Institute. Recently, she completed a five year term as President of the Canadian Institute of International Affairs.

Mrs. McDougall chaired the 2007 Lionel Gelber Prize jury. She is the Federal Representative regarding Six Nations Land Claims, is an honorary governor of York University, a director of the Canadian Opera House Corporation, and the founding Chairperson of the Patron's Council of the Toronto Association for Community Living. She is also a columnist and television commentator.

Prior to entering politics, Mrs. McDougall worked in various sectors within the financial community, largely as a financial analyst, in Vancouver, Edmonton and Toronto.

Mrs. McDougall is an Officer of the Order of Canada and is an Honorary Patron of the Genesis Research Foundation.

Dr. Gordon Thiessen was appointed Governor of the Bank of Canada on February 1, 1994, for a term of seven years, retiring on January 31, 2001. Mr. Thiessen studied economics at the University of Saskatchewan and received an Honours B.A. and M.A. He also lectured in economics at the University. Thereafter, he attended the London School of Economics, from which he received his Ph.D. in Economics. He joined the Bank of Canada in 1963 and worked in both the Research and the Monetary and Financial Analysis Departments of the Bank. Mr. Thiessen spent the period from 1973 to 1975 as a visiting economist at the Reserve Bank of Australia. In 1996, the government of Sweden awarded Mr. Thiessen the Order of the Polar Star in recognition of the assistance provided by the Bank of Canada to the Swedish central bank. In 1997, Mr. Thiessen received a honourary Doctor of Laws degree from the University of Saskatchewan, and in 2001 a honourary Doctor of the University degree from the University of Ottawa. He became an Officer of the Order of Canada in 2003. In 2002, Mr. Thiessen became the Founding Chair of Canada's new auditor oversight agency, the Canadian Public Accountability Board. He served in that position until 2008. He has also served on the boards of corporations, a university, and a research organization, as well as a number of investment committees.

Mr. John M. Weekes, a 38-year veteran in the field of trade policy and negotiations, is currently a senior business adviser with the law firm Bennett Jones LLP. From 2003 to July 2009, Mr. Weekes was senior policy adviser at Sidley Austin LLP, based in the firm's Geneva office, and continues to act as senior international trade policy adviser to the firm. Prior to joining the firm, he was chair of the global trade practice at APCO Worldwide, an international public affairs and communications consultancy. Mr. Weekes was Canada's Ambassador to the WTO from 1995 to 1999 and Chair of the WTO General Council in 1998. He served as Canada's Chief Negotiator for the North American Free Trade Agreement (NAFTA), including the side agreements on environmental and labour cooperation. He was Ambassador to GATT during the Uruguay Round negotiations and Chair of the GATT Council in 1989 and then of the GATT Contracting Parties in 1990. In the 1970s, he participated in the Tokyo Round of GATT negotiations. Mr. Weekes is an active member of the Board of Alberta Livestock and Meat Agency and serves on the board of, or as adviser to, a number of non-profit organizations. He is a frequent speaker on the challenges facing the trading system and related political issues, participates regularly in conferences, and contributes articles to newspapers and magazines.

Special Guests

Dr. Fen Osler Hampson is Chancellor's Professor and the Director of The Norman Paterson School of International Affairs (NPSIA), Carleton University, Ottawa. Dr. Hampson is also Senior Advisor to the United States Institute of Peace, member of the Board of Directors of the Pearson Peacekeeping Centre, and member of the Social Science Foundation Board at the University of Denver. Dr. Hampson is the author/co-author of eight books and more than eighty articles and book chapters on international affairs, as well as editor/co-editor of more than twenty-eight other volumes. He is the past recipient of various awards and honours, including a Research & Writing Award from the John D. and Catherine T. MacArthur Foundation and a Jennings Randolph Senior Fellowship from the United States Institute of Peace in Washington, D.C. He has also taught at Georgetown University as a Visiting Professor. Dr. Hampson is a frequent contributor to the national and international media, including the Washington Post, The Globe and Mail, Foreign Policy Maganize, the National Post and the Ottawa Citizen. He is a frequent commentator on the CBC, CTV, and Global news networks. He holds a Ph.D. from Harvard University where he also received his M.A. degree (both with distinction). He also holds a M.Sc. (Econ.) degree (with distinction) from the London School of Economics and a B.A. (Hon.) from the University of Toronto.

French Delegation

Co-Chair

Dr. Jean Pisani-Ferry has been since January 2005 director of BRUEGEL (for *Brussels European and Global Economic Laboratory).* He is also a professor of economics with *Université Paris-Dauphine.* Pisani-Ferry has made his career in research and policy. After having held positions in research and government in France, he joined the European Commission in 1989 as economic adviser to the Director-General of DG ECFIN. From 1992 to 1997 he was the director of CEPII, the main French research centre in international economics. In 1997, he became senior economic adviser to the French minister of Finance and was later appointed executive president of the French prime minister's Council of Economic Analysis (2001-2002). From 2002 to 2004, he was senior adviser to the director of the French Treasury.
Pisani-Ferry has held teaching positions with various universities including *Ecole polytechnique* in Paris and *Université libre de Bruxelles.* In 2006-2007, he was president of the French economic association.
He is a member of the *Council of Economic Analysis*, an independent advisory body reporting to the French PM.
Born in 1951, Pisani-Ferry was initially trained as an engineer and also holds a Master in mathematics. He holds an advanced degree in economics from the *Centre d'études des programmes économiques* (CEPE, Paris).
Pisani-Ferry has regular columns in *Le Monde, Handelsblatt*, and the Chinese magazine *Caixin.* He is a contributor to *The Economist*'s by invitation blog and to *Project Syndicate*.

Presenters, Discussants and Moderators

Mr. Denis Beau is Deputy Director General, Economics and International, at the Banque de France since October 2008. He previously held several positions related to Banque de France's monetary policy and financial stability activities. Denis Beau also served at the Bank for International Settlement as Secretary of the G10 Committee on Payment and Settlement Systems.
Denis Beau is a graduate of Institut d'Etudes Politiques de Paris and he received a Master degree in Business Administration from INSEAD.

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