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From London to L'Aquila

Building a Bridge between the G20 and the G8

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Summary points

- From many perspectives, the London Summit of the G20 leaders at the beginning of April 2009 was a success – and a hard act to follow. The discussion was framed around crisis resolution and the strengthening of the international financial architecture.
- Beyond any concrete achievement, the success of the London Summit is that it morphed into an ongoing process with a rolling agenda, rather than remaining a one-off event.
- Undoubtedly the Italian Presidency of the G8 has a hard task, being caught between the success of London and the decreasing relevance of the G8. But there is also scope for building a meaningful bridge between London and the G8 meeting in L'Aquila in July 2009, and continuing and strengthening the economic governance reform process.
- There is an urgent need to continue to push for progress on a number of key items that were not adequately addressed at the London Summit and where progress can be made in L'Aquila – fostering clarity for the G20 agenda for the next meeting in Pittsburgh in September 2009.
- With regard, in particular, to the reform of the International Monetary Fund, the Italian Presidency should use its G8 chair to initiate a dialogue on reform of the European representation, taking advantage of having all the key players gathered together in L'Aquila.

Introduction: the unfinished agenda

From many perspectives, the London Summit of the G20 leaders at the beginning of April 2009 was a success. Its main achievement – and real novelty – was to address and discuss the reform of the international financial architecture within the context of the current financial crisis. Following talks that had begun at the first G20 leaders' summit in Washington in November 2008, the focus became both more specific and wider in London. Here the discussion was framed around two key areas: crisis resolution and the strengthening of the international financial and monetary architecture. The outcome was a number of reforms to the content and governance of international financial regulation, designed to head off future crises. The G20 leaders addressed the immediate crisis in other important ways, most notably through their commitment to empower the International Monetary Fund (IMF) as a crisis resolution institution by increasing the resources available to it.

The achievements of the G20 London Summit make it a difficult act to follow. Undoubtedly the Italian Presidency of the G8 has a hard task, being caught between the success of London and the decreasing relevance of the G8. However, there are a number of areas where the G20 leaders fell short in addressing both the need for immediate crisis resolution and future crisis prevention, as well as the broader issue of the governance of economic international institutions. As a result, the Italian Presidency has the opportunity to build on key gains from the London Summit, and to make progress on key items that were not adequately addressed there, creating a meaningful bridge between London and L'Aquila.

Policy coordination in a time of crisis

Trying to reach agreement on coordinated fiscal measures to boost demand in the main economies was one of the stickiest points in London and risked derailing the meeting. In the end the view of 'sharing the burden together' to resolve the crisis prevailed, as did the recognition that the global crisis required global solutions with the participation of all countries and with due consideration of the impact of actions on developing countries.

The question of a coordinated policy response at a time of crisis – which does not necessarily mean a coordinated fiscal stimulus – remains on the agenda and should be picked up for discussion in L'Aquila. What emerged in London, and should provide a thread for discussion among the G8, was the awareness that policy coordination is necessary since the impact of the crisis is too large for countries to deal with on an individual basis. It is also necessary to implement reforms of financial markets and institutions as well as to mitigate the impact of bailout plans and stimulus packages on neighbouring economies and trading partners. Even if these measures fall within the remit of domestic economic policy, they can have an adverse impact on other countries, triggering protectionist responses and retaliation.[1] Recent experience shows that even small countries, such as Iceland, can be the source of significant spillovers. However, mechanisms to ensure that national policies are undertaken with external as well as domestic consequences in mind remain inadequate.[2]

To signal their support for policy coordination, the G20 leaders in London endorsed 'candid, even-handed, and independent IMF surveillance'. But the details

The G20's unfinished agenda

- The Summit failed to define a coordinated plan to identify and clear out toxic assets from the banking sector.
- Details are still to be worked out concerning the implementation of macroprudential regulation.
- There was no concrete and substantive reform of international institutions, most notably the IMF.
- No new deadline was set to complete the Doha round of trade talks. No strong legal measures (as opposed to non-binding pledges) were taken to ensure countries do not introduce further protectionist trade policies.

1 There are signs of tensions, for instance, between Canada and the US following the 'Buy American' clause in the US fiscal stimulus bill. Not only do protectionist measures risk damaging trading relations and sparking tit-for-tat responses but they are difficult to implement in internationally integrated supply chains. Requiring companies to change their sourcing arrangements to host country creates extra costs and assumes the extra production capacity is in place there, when it may not be.

2 Barry Eichengreen, 'Out of the Box Thoughts about the International Financial Architecture', IMF Working Paper, May 2009, pp. 1–26.

concerning macroeconomic policy coordination, particularly *vis-à-vis* global imbalances, were not spelled out. Further indications on this matter emerged at the IMF Spring Meetings in April where there were calls to improve the surveillance process. The G8 Summit could demonstrate political will by developing some concrete proposals for the reform of the IMF's surveillance role.

In their London Summit communiqué, the G20 leaders reiterated the commitment made in Washington to trade and investment openness: 'We will minimize any negative impact on trade and investment of our domestic policy actions including fiscal policy and action in support of the financial sector'. Given the trend for countries to resort to protectionist measures since the financial crisis worsened in November – 55 of the 77 trade measures enacted around the world were trade-restrictive – the challenge for the G20 was to substantiate this statement with some concrete measures, such as ensuring the availability of $250 billion over the next two years to support trade finance. The leaders reiterated their commitment to a quick and successful conclusion to the Doha round of trade negotiations, which, according to their communiqué, 'could boost the global economy by at least $150 billion per annum'. However, no new deadline was set to complete the Doha round, which has been in discussion for eight years.

Strengthening international financial regulation …

At the Washington Summit, the G20 leaders had focused primarily on the forward-looking task of reforming international financial regulation in the light of lessons learned from the crisis. This issue remained a prominent item on the agenda at the London Summit, and the leaders went beyond the commitments outlined in their 'Washington Action Plan'[3] in a number of ways. Tax havens that did not meet international standards on tax information exchange were now warned that the G20 stood ready to take a number of immediate specific actions ranging from the imposition of withholding taxes to forced reporting of transactions with non-cooperative jurisdictions. The G20 leaders also signalled that tax havens would soon face pressure to comply with international prudential and supervisory standards as well. Countries on the tax haven 'grey list' such as Luxembourg are currently working hard to establish free exchanges of tax information to enable them to be removed from the list by the next G20 meeting in September.[4] There have been suggestions that a new amnesty on tax havens may be on the agenda at L'Aquila – with the aim of regularizing billions of dollars currently held in overseas havens by encouraging individuals to come forward and declare their funds.

In addition, the London Summit strengthened international regulations relating to bond rating agencies, compensation issues involving significant financial institutions, derivatives and hedge funds. It is crucial that the political momentum behind these goals be maintained and that national and regional initiatives continue to work towards them. For these reasons, at the July Summit G8 leaders should re-emphasize the importance of their implementation.

Even more ambitiously, the G20 leaders tasked the IMF and the Financial Stability Board (FSB) with the job of producing guidelines for national authorities 'to assess whether a financial institution, market, or an instrument is systemically important' in order that regulation and supervision be extended to these entities. They went out of their way to insist that 'these guidelines should focus on what institutions do rather than their legal form'.[5] The guidelines raise the question of whether systematically important institutions should be subject to higher standards or restricted from certain high-risk activities, as some have suggested. The G20 leaders dodged this question at the London Summit, but it will soon have to be faced more squarely. The G8 summit could help accelerate this discussion.

3 In Washington the G20 leaders agreed on a work plan – 'the Washington Action Plan' – to implement five agreed principles for reform. G20, Washington Action Plan: 'Action plan to implement principles for reform', 15 November 2008, http://www.londonsummit.gov.uk/en/summit-aims/washington-follow-up/washington-action-plan1/.

4 To be removed from the OECD's grey list, a country must have set up information-exchange agreements with at least 12 countries. Luxembourg has completed its fourth agreement, with France, in June (after the US, the Netherlands and Bahrain).

5 G20, Communiqué from the London Summit: 'Global plan for recovery and reform', Annex 'Declaration on Strengthening the Financial System', http://www.londonsummit.gov.uk/en/summit-aims/summit-communique/, 2 April 2009, p. 3.

Another important achievement in London was the endorsement of detailed proposals to integrate 'macroprudential' concerns into international financial regulation. Historically, international prudential regulation has focused at the micro-level of the soundness of specific institutions and markets rather than larger factors that might contribute to a system-wide build-up of excessive risks. The Washington Action Plan had already broken new ground by asking officials in the Financial Stability Forum and other bodies to develop recommendations to address the 'pro-cyclicality' of existing rules and practices. The G20 leaders in London then backed a number of specific proposals relating to bank regulation and accounting practices that emerged on this macroprudential agenda, and set the end of 2009 as the deadline for their implementation.

These new detailed proposals are welcome, but important questions remain about their implementation that the G20 leaders did not address. The most important concerns the division of home and host country responsibilities *vis-à-vis* the regulation of banks. Although existing practice emphasizes home country control, the new macroprudential regulations strengthen the case for host countries to take more of the lead because credit cycles vary across countries. Indeed, some argue that the case for host country control has been boosted more generally by the experience of financial rescues during the financial crisis, where host countries have ended up assuming the burden. Whatever the costs and benefits of home vs. host country control, the push for macroprudential regulation has guaranteed that this jurisdictional issue requires much more attention from policy-makers.

… and its governance

The London Summit broke new ground in reforming not just the *content* of international financial regulation but also its *governance*. Since the beginning of the global financial crisis, the FSF had played the lead role in coordinating the international regulatory response. The London Summit renamed it the Financial Stability Board and widened its mandate. It was assigned the job of collaborating with the IMF in conducting early-warning exercises as well as setting guidelines and supporting the creation of supervisory colleges for large cross-border firms. It was also tasked with undertaking 'joint strategic reviews of the policy development work of the international standard setting bodies to ensure their work is timely, coordinated, focused on priorities, and addressing gaps'.[6] Membership of the body also now came with the responsibility of implementing twelve key existing international standards and codes, and undergoing periodic peer reviews. The membership of the FSB was also widened beyond the G7 countries, Australia, Hong Kong, the Netherlands, Singapore and Switzerland to include all G20 countries as well as Spain and the European Commission.[7] It is not yet clear how many representatives the new members will be assigned. Before the expansion, there were two classes of members: the G7 countries each had three representatives (finance ministry, central bank, and supervisory authority), while the other five were only allowed one representative each. The FSF simply announced at the time of the London Summit that the number of seats would 'reflect the size of the national economy, financial market activity and national financial stability arrangements'.[8]

An even more important issue that requires attention is the accountability of the FSB to all the other countries which are not members. This issue is likely to become increasingly politicized given the FSB's new prominence as one of the central pillars of global financial governance. One small way in which this was addressed at the London Summit was through the requirement that the FSB, along with the IMF, report to the International Monetary and Financial Committee of the IMF on their early warning

6 Ibid, p. 1.

7 The body also includes international financial institutions, international regulatory and supervisory groupings, committees of central bank experts, and the European Central Bank.

8 FSF, 'Financial Stability Forum Re-established as the Financial Stability Board', Financial Stability Forum Press release 14/2009, 2 April 2009, p. 1, http://www.financialstabilityboard.org/press/pr_090402b.pdf.

9 G20, 'Declaration on Strengthening', p. 1.

exercises concerning 'the build up of macroeconomic and financial risks and the actions needed to address them'.[9] Provisions were also made for non-member countries to be included in the FSB's ad hoc working groups. In addition, it was announced that the new body 'will step up its regional outreach activities to broaden the circle of countries engaged in work to promote international financial stability'.[10] In L'Aquila, the G8 leaders could highlight their support for the development of further mechanisms that enable non-FSB countries, particularly low-income ones, to have their voices heard in international financial regulatory discussions.

The resources and governance of the Bretton Woods institutions

The FSF/FSB was not the only international financial institution to see its role strengthened or expanded by the London Summit. Even more dramatic was the strengthening of the IMF's lending facilities in order to provide aid to countries in need of financial assistance. This move was an important step towards the review of the adequacy of the resources of the IMF, the World Bank Group and other multilateral development banks that the Washington Summit indicated as an objective for the G20 meeting in London.

In London the G20 leaders welcomed the IMF's decision to create a 'flexible credit line' to grant rapid upfront financing in large amounts for 'strongly performing economies that needed insurance to protect them from crisis fallout'.[11] This is particularly useful for crisis prevention purposes as it provides the flexibility to draw on the credit line at any time. Access is restricted to countries that meet strict qualifying criteria. However, once a credit line has been approved, disbursements are not phased, nor are they conditional on compliance with policy targets, as is normally the case for IMF loans.[12] On the eve of the London Summit, Mexico stated that it intended to apply for a precautionary credit line of $47 billion under the new scheme. A few weeks later Poland filed an application for a precautionary credit line of $20.5 billion and Colombia for $10.4 billion.

In London it was also agreed to make the IMF's lending and conditionality framework more flexible, so that, as the communiqué stated, the IMF can address 'effectively the underlying causes of countries' balance of payments financing needs'. Rather than on specific actions that need to be adopted, the focus will be on the underlying objectives of a country's structural reform agenda, based on key actions agreed with the country at the outset of the loan programme that will serve as benchmarks. The new framework will apply to all IMF loan programmes, including those with low-income countries.

In line with one of the two objectives for the reform of the Bretton Woods institutions that were set at the Washington Summit, the G20 leaders agreed in London 'to increase the resources available to the IMF' and addressed the issue in a way that provided much more detail and new initiatives. The agreement is quite innovative as it combines various proposals – New Arrangements to Borrow (NAB), special drawing rights (SDRs), gold sales, market borrowing for IMF. In their London Summit communiqué, the G20 leaders agreed 'to treble resources available to the IMF to $750 billion, to support a new SDR allocation of $250 billion, to support at least $100 billion of additional lending by the MDBs [multilateral development banks], to ensure $250 billion of support for trade finance, and to use the additional resources from agreed IMF gold sales for concessional finance for the poorest countries'. The SDR issue is particularly surprising and impressive, given the recent history of failed efforts to boost it, and has been positively picked up by China.

Actual numbers, however, remain somewhat ambiguous, in particular the breakdown of the financial resources allocated to the IMF. According to the London Summit communiqué, the increase in the resources available can be achieved 'through immediate financing from

10 FSF, 'Financial Stability Forum Re-established as the Financial Stability Board' , 2 April 2009, p. 1,

11 More Needed to Revive Global Economy, Says IMF' IMF press release, 16 April 2009, http://www.imf.org/external/pubs/ft/survey/so/2009/new041609a.htm.

12 This is an important point for developing countries relative to the established G7 position – and a sign that the Washington Consensus might be over, as Gordon Brown said in the post-London Summit press conference.

members of $250 billion, subsequently incorporated into an expanded and more flexible New Arrangements to Borrow, increased by up to $500 billion, and to consider market borrowing if necessary'.

Some countries or regions, such as Japan and the European Union, have committed resources directly to the IMF. In the specific case of Japan, $100 billion had already been made available at the time of the Washington Summit. Some countries have committed smaller amounts – both Canada and Switzerland $10 billion, and both Norway and Brazil $4.5 billion. Others made less firm commitments. China, for instance, was said to be willing to buy $50 billion in bonds issued by the IMF. Beijing's willingness to consider contributing to the IMF liquidity is a significant follow-up from the London Summit – thanks to a thorough preparation in the weeks before the meeting. Back in November, China had made it clear that supporting its domestic economy was its most pressing policy priority and it had responded to mounting international pressure to contribute funds to the IMF's liquidity by stating unequivocally its unwillingness to comply with such a request.

However, the amount of funds so far raised is only half the total that the G20 leaders indicated as necessary to provide appropriate assistance to countries in financial need. Even though the US has now confirmed its offer of $100 billion,[13] it is not clear where the rest will come from as no other country has so far signalled the intention of providing significant funding.

Governance and representation

In terms of the second of the two objectives that were set up at the Washington Summit – the governance of the international financial institutions – not much was achieved in London besides the broad agreement, confirmed in the final communiqué, 'to reform and modernise the international financial institutions to ensure they can assist members and shareholders effectively in the new challenges they face'. The G20 leaders insisted that 'emerging and developing countries, including the poorest, must have greater voice and representation', but announced few details about how this would be done. To be sure, they addressed the long-standing issue of leadership selection with the commitment that heads of international financial institutions should be appointed 'through an open, transparent, and merit-based selection process'. However, this still leaves quite unaddressed the much bigger issues of revising quotas, realigning the Executive Board and reforming voting procedures. Legitimacy and accountability to its members are critical for the IMF to fulfil its mandate effectively. Enlarging the emerging-market representation is fundamental in terms of reflecting structural changes in the international economic order.

The G20 leaders stressed governance reform as a medium-term goal and made a commitment to accelerate reform of country representation to early 2011. At the IMF Spring Meetings, the International Monetary and Financial Committee urged a prompt start to the fourteenth general review of IMF quotas to ensure completion by January 2011, stressing that NAB 'is not a substitute for a quota increase'.[14] On the same occasion, the ministers in the 15-member African Consultative Group stressed the need to accelerate reforms of governance to amplify Africa's voice within the IMF.

An overhaul of the Executive Board with a view to improving the representation of developing countries implies reassessing the European representation so as to reflect the economic weight not just of Germany, France and the UK but of the EU as a whole. This might eventually lead to the collapsing of the three European seats – Germany, France and the UK – into a single EU seat.[15] If the EU were to combine into a single constituency with a reduced combined quota of votes, that would also release a very significant quota for realignment, as well as giving the Europeans much more concentrated weight. An EU constituency would have a veto, giving it real voting power.[16]

13 'US Congress Vote Marks Big Step for IMF Reform, Funding', IMF Survey online, 18 June 2009, http://www.imf.org/external/pubs/ft/survey/so/2009/NEW061809A.htm.

14 'Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund', IMF Press Release No. 09/139, 25 April 2009, http://www.imf.org/external/np/cm/2009/042509.htm.

15 *New Ideas for the London Summit: Recommendations to the G20 Leaders*, Chatham House and Atlantic Council Report, London, April 2009.

16 Lorenzo Bini Smaghi, 'A Single EU Seat in the IMF?', *Journal of Common Market Studies*, Vol. 42, No. 2 (2004), pp. 229–48.

With all the key players gathered together, including the US which, *de facto*, holds a veto under the current IMF voting procedure, the Italian Presidency should seize this opportunity to initiate the dialogue and assess the concrete steps that are needed to move towards consolidated representation of European countries on the IMF executive board. Discussing the EU representation within the IMF is politically difficult, but it cannot be avoided for much longer. Europe should show leadership and be the 'first mover', rather than be eventually forced to confront the question of IMF governance. In this respect it would be easier for the Italians to raise the issue, given that Italy does not have a seat on the IMF's board. What is at stake is Europe's relevance at the international level – especially critical in view of the increasingly intense US–China dialogue. Europe's 'big four' therefore have a responsibility as well as the interest to bring up such a dialogue and move it forward. In this respect, the L'Aquila Summit provides the best opportunity to bridge the policy gap between the G20 and the G8, and to give some teeth – and relevance – to the latter.

Conclusion: towards L'Aquila

The London Summit was preceded by a combination of high expectations and scepticism as to what it could concretely achieve. The agenda was undoubtedly ambitious, stretching from short-term stabilization of financial markets and lifting the real economy out of recession to the reform of the international financial and monetary architecture. In the run-up to the Summit, however, diplomatic efforts intensified to enable agreement to be reached on some key issues. As a result, the G20 leaders delivered on some bare essentials and set up a number of building blocks for future talks.

As discussed above, the London Summit's main accomplishments relate to future crisis prevention, especially in terms of strengthening international financial regulation, the FSB and the IMF. Over and above this, the Summit did much to restore confidence as the G20 leaders showed some commitment to international policy coordination and multilateralism. Some of these points were turned into concrete action. As noted, the pledge to enhance the IMF's lending facilities through bilateral borrowing in order to aid countries in need of financial assistance has already provided assistance to Mexico, Poland and Colombia. Similarly, on the regulatory framework some important new proposals emerged, particularly regarding hedge funds, compensation schemes and tax havens. Some of these questions, however, though resonating well with public opinion, are not critical in crisis resolution.

Recommendations

- The Italian Presidency should use its G8 chair to initiate the dialogue on the reconfiguration of the number of seats and votes in the IMF to better reflect the economic and political realities of the 21st century. This should involve discussing and assessing a number of options for reform of the European representation, including an overhaul of the Executive Board and collapsing the European seats – Germany, France and the UK – into a single EU seat.
- G8 leaders should make clear their support for the development of further mechanisms that enable non-FSB countries, particularly low-income ones, to have their voices heard in international financial regulatory discussions.
- The G8 should spell out and reach agreement on how to implement coordinated macroeconomic policy responses particularly *vis-à-vis* global imbalances. In addition, the impact of bailout plans and stimulus packages on neighbouring economies and trading partners should be monitored and mitigated.
- The G8 Summit should demonstrate political will by developing some concrete proposals for the reform of the IMF's surveillance role.
- The G8 should maintain the political momentum behind London Summit measures on strengthening international regulations relating to bond rating agencies, compensation issues involving significant financial institutions, derivatives, tax havens and hedge funds, and re-emphasize the importance of their implementation.
- The G8 summit should address the question of what action is still necessary for the financial sector to clean banks' balance sheets. It should also help accelerate the discussion on whether systematically important institutions should be subject to higher standards or restricted from certain high-risk activities.

Immediate action still required for the financial sector entails cleaning banks' balance sheets.

Relative to the G20's Washington meeting, the London Summit undoubtedly achieved a considerable amount. But beyond any concrete achievement, its success is that it morphed into an ongoing process with a rolling agenda, rather than remaining a one-off event.

Because of the complexity of the agenda and the intricacies of dealing with so many players around the table, several issues were rolled over to the next meeting – or were simply left out. Some will be on the agenda of the next G20 meeting in Pittsburgh in September. Others can be picked up at the forthcoming G8 Summit. Even though the G8 agenda is much broader and includes a wider variety of issues – such as development, security, Africa or climate change – there is an urgent need to continue to push for progress on the London Summit issues, particularly since it seems that many G20 members have gone off and 'done their own thing' since April. Moreover, some matters may well benefit from discussion in the more 'intimate' G8 setting.

It is now up to the Italian Presidency of the G8 to put some of these issues on the agenda for the L'Aquila Summit. Particularly relevant is the question of the European representation in the IMF. The London Summit was unable – and unwilling – to address the question of the governance of the IMF, leaving the reform of quotas and voting rights to 2011. However, this deadline is too far away for what is increasingly regarded as an urgent issue. The Italian Presidency has an opportunity to send a strong signal and initiate the dialogue on reform of the European quota within the IMF, and should promote the idea of a single EU constituency. Most of all, it should seize the opportunity to link major economic discussions between the G8 leaders and key partners among developing countries, indicating that action is needed in the short term and ensuring clarity for the G20 agenda for Pittsburgh in September.

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