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PRIORITIZING INTERNATIONAL MONETARY AND FINANCIAL COOPERATION FOR THE G20

VIEWS FROM THE T20

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Key Points

- In order to boost the participation of emerging market economies (EMEs) in the international monetary system and demonstrate that the International Monetary Fund (IMF) still has an important role, the Group of Twenty (G20) should push for a broadening of the Special Drawing Rights (SDR) basket, an increase in the allocation of SDRs and reintroduction of the reconstitution requirement.
- The G20 should push forward on an agenda to establish a more globally consistent macroprudential policy framework. G20 leaders should also agree on early implementation of an internationally consistent regime for the restructuring and resolution of distressed global systemically important financial institutions (G-SIFIs) in order to address "too big to fail" (TBTF).
- The G20 should seek widespread implementation of the proposed International Capital Markets Association (ICMA) debt contract standards, and promote transparency and regulation of sovereign credit default swaps (SCDSs). It should also promote greater debate on the merits of a transparent, predictable and comprehensive framework for managing severe sovereign debt crises.
- The G20 needs to take the lead in establishing climate change and other environmental risks as the largest threat to the global economy and financial system. In doing so, it should, among other actions, be more transparent and ambitious in ending fossil fuel subsidies and deal with the issue of stranded assets.

Introduction

At the height of the global financial crisis (GFC) in 2008-2009, the G20 proved itself to be an effective forum for coordinating a global policy response. Yet, six years later, several of the frailties that were key causes of the crisis still need to be adequately addressed, including weak international organizations and systemic risks in the shadow banking sector. Furthermore, longer-term risks from climate change and environmental degradation, geopolitical conflicts and global health pandemics can no longer be placed at the sidelines of economic policy discussions, as emphasized by the Right Honourable Paul Martin, former prime minister of Canada, in his opening address at the Think 20 (T20) conference held in Ottawa on May 3–5, 2015 (see Box 1).

Against this backdrop, the T20 gathered to focus on issues pertaining to international monetary and financial cooperation in a meeting co-hosted by the Centre for International Governance Innovation (CIGI) and The Economic Policy Research Foundation of Turkey (TEPAV), the T20 chair (see Box 2 for a background on the T20). The purpose of the conference was to distill recommendations on several substantive issues where progress should be made during the Turkish G20 presidency: enhancing SDRs in an evolving international monetary system; addressing global macroeconomic imbalances and macroprudential regulation; improving the management of severe sovereign debt crises; advancing international financial regulatory reforms; and addressing increasing environmental and sustainability risks through regulatory reforms.

Box 1: Excerpts from Paul Martin's Opening Address

Former Prime Minister of Canada Paul Martin delivered the opening address at the T20 conference, which set the tone of the meeting and inspired a longer-term perspective on the role of the G20 in global governance. The following excerpts are from that speech:*

> "The purpose of G20, with its many cultures, religions and political systems, is to make globalization work in a world of differences."
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> "Now and over the years to come, the issues the G20 will have to confront will be as varied as there are pebbles on the beach. From increasing economic interdependence to the migration of people, from the spread of disease to threats to food security, for better or for worse, the most pressing realities the world faces are ones no borders can withstand."
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> "While cross-country bargaining will inevitably begin on the basis of the self-interest of nations, in the end success will only be achieved if the member countries grasp the unassailable truth that the furtherance of a country's self-interest will depend more and more on the degree to which it furthers the global interest."
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> "It is in this context that the importance of the great multilateral institutions must be underlined for it is they who have been delegated much of the responsibility for ensuring that globalization works. It is here as well that the G20's primary responsibility, which is to ensure the strength of those institutions, becomes self-evident. Indeed it is upon this that much of the G20's legitimacy rests."
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> "The G20 was brought into being so that international co-operation would reflect the needs of a changing world. That co-operation begins with the strengthening of the institutions created to make globalization work. This should be a G20 priority."

* The speech is available at: www.theglobeandmail.com/globe-debate/why-the-g20-must-revitalize-our-global-institutions/article24236844/.

Box 2: T20 — A Backgrounder

The T20 is an informal network of think tanks, academics and researchers representing the G20 and, upon invitation, non-G20 member countries. Its purpose is to provide analytical support that informs the G20 processes and policy decisions with the aim to advance global economic governance.

The Mexican G20 presidency, in collaboration with the Mexican Council on Foreign Relations, brought more structure to the T20, which was already active as a network, by fostering greater interaction between think tank experts and G20 officials. Russia and Australia continued the T20 process during their respective G20 presidencies. Under the Turkish presidency, the T20 is breaking new ground by increasing the level of engagement among T20 participants, between the T20 and other outreach groups and, in particular, by tightening the linkage between the T20 and G20 policy makers. During the inaugural G20 ministerial meetings in Istanbul on February 10, 2015, the T20, convened by CIGI and TEPAV, had a joint session with a delegation of G20 finance ministers and central bank governors to discuss and appraise the agenda under the Turkish presidency.

Unlike other engagement groups, the T20 is not an advocacy group that campaigns for specific issues and policy solutions; instead, the T20 provides analytical support and policy recommendations that aim to enhance G20 processes, specifically, and advance global economic governance in general. The T20 aims to produce value-added research, leveraged on its analytical capacity and diversity, to identify governance gaps and suggest new policy solutions that take into account political constraints. Ultimately, the goal is to deliver research and analysis that advances the G20's agenda and strengthens its effectiveness as the premier forum for economic cooperation.

The following is a stock-taking of the proceedings, which involved representatives of think tanks from G20 countries, leading international experts and a number of senior officials.

Enhancing SDRs in an Evolving International Monetary System

Since the G20's inception, its purpose has been to broaden the participation of EMEs on issues concerning global economics and finance.[1] As early as 2005, China's presidency took aim at reforming the Bretton Woods institutions to be more inclusive and progressive in adapting to the changing global economic landscape. The G20 has already successfully championed a number of changes to IMF governance, including increasing its financial resources, boosting its role in surveillance, expanding its lending facilities and reorganizing its financial model. At the height of the GFC, the G20 also supported a new allocation of SDRs to ensure adequate liquidity in the global financial system. Despite endorsement from the G20 leaders and approval by the IMF governance bodies, the US Congress has yet to ratify the proposed quota reform that would both increase the IMF's permanent financial resources and rebalance voting shares in favour of dynamic and underrepresented member countries, offering a stronger voice for EMEs.

Against this backdrop, later this year, the IMF executive board will undertake the quinquennial review of the SDR currency valuation basket. Such a review offers the opportunity to increase the participation of EMEs in the global financial system. The following recommendations to strengthen the relevance of the SDR emerged out of the T20 discussion on this matter:

- **Broaden the SDR basket:** As the currencies of large EMEs make advances in internationalization, the IMF should be prepared to add these currencies to the SDR basket without necessarily waiting for the next quinquennial review. Including the currencies of EMEs in the SDR basket would facilitate currency diversification in the international

1 See www.g8.utoronto.ca/finance/fm992509.htm.

monetary system and demonstrate the important role of EMEs in the global financial system, therefore helping to strengthen the perception of the IMF's legitimacy. The Chinese renminbi appears to be the first candidate for inclusion, but the IMF should continue to monitor the internationalization of the currencies of other large EMEs — such as India's rupee — as these countries move toward convertibility of their currencies for transactions in both the current and capital accounts.

- **Increase allocations of SDRs:** The IMF should issue SDRs on a regular schedule and in large enough quantities to ensure that the asset gains a meaningful role in the international financial system. In order for the SDR to be an effective reserve asset, it needs to sustain a significant proportion of foreign exchange reserves. Decisions on the allocation of the SDRs occur every five years, and the next decision is to be taken in 2016.
- **Reinstate the reconstitution requirement:** The reconstitution requirement posits that countries restore their SDR holdings within a specified time period. This requirement was included in the original SDR scheme to ensure that participating countries would, in the long run, hold a substantial portion of their allocations as reserves. This was later phased out and eventually suspended in an attempt to support a more flexible SDR market. Requiring countries to rebuild SDR reserves when they become depleted would ensure that the market remains liquid and that the asset is not being misused as a lender-of-last-resort for sovereigns.
- **Facilitate transactions:** The most effective way for SDRs to help prevent liquidity crises is for the IMF to establish a substitution account for the voluntary, off-market conversion of foreign exchange reserves into SDRs. By facilitating access to hard money by deficit countries, the IMF could diminish credit risk for surplus countries and reduce the volatility of foreign exchange markets. The proposals suggested above could, therefore, act as stepping stones toward a more robust role for the SDR as a freely convertible reserve asset.

Global Macroeconomic Imbalances and Macroprudential Regulation

In an effort to counteract the potentially devastating consequences of the GFC, a number of advanced economies began easing monetary policy in ways that quickly resulted in interest rates approaching or reaching the zero lower bound (ZLB). The central banks in several of these countries subsequently introduced quantitative easing programs in an effort to ensure that monetary policy remains effective at stimulating macroeconomic activity at the ZLB. However, these extraordinarily accommodative monetary policies may be encouraging the buildup of longer-term risks through the search for yield and, by doing so, counteracting ongoing efforts at strengthening financial regulation to address the risks that caused the crisis in the first place. More broadly, the combination of "low-for-long" policy interest rates, coupled with uncertainty over the speed of interest rate adjustments and their eventual long-term levels, risk creating the conditions for acute financial and exchange rate volatility. Innovation in central bank communication policies can help mitigate these risks to some extent, but financial market participants' reliance on communication of policy paths may also intensify the reaction to economic shocks that cause these paths to change course. Against this background, the following recommendations were put forward by conference participants:

- **Utilize the full macroeconomic policy tool kit:** The central bank should not be the be-all and end-all of macroeconomic policies: not only does this lead to suboptimal policies, it may also foster the buildup of systemic risks. Fiscal stimulus may be necessary in some countries to address shortfalls in aggregate demand.[2] Perhaps more importantly, stronger macroprudential frameworks are necessary in most countries, but policy makers must recognize that these are tools to manage longer-term risks rather than fine-tuning operations.
- **Establish a globally consistent macroprudential policy framework:** The highly integrated and increasingly complex global financial system requires stronger macroprudential regulatory oversight to prevent acute volatility. Participants suggested four measures that can be taken to advance a multilateral macroprudential policy framework: step up research on an analytical framework for identifying the buildup of systemic risks; introduce flexibility in capital and liquidity buffers to prevent contagion from the fire sale of assets during crises; implement reporting standards for systemically important financial institutions (SIFIs) to ensure the consistency of data; and make aggregate, real-time information on evolving risk levels and concentrations in various sectors publicly available so that markets can appropriately price-in broader system-wide risks.
- **Intra-G20 policy guidance:** The G20 should try to foster open and transparent communication among members. This could take the form of formalized, closed-door multilateral policy guidance where policy makers discuss their outlook for the path of domestic interest rate and exchange rate policies, so that affected members can respond appropriately to prevent destabilizing spillovers and financial cycles.

2 The language used by G20 finance ministers and central bank governors in their communiqué in April 2015 is a welcome step in recognizing the centrality of fiscal policy in addressing demand shortfalls.

This type of communication would help build trust among members, establishing the groundwork for future macroeconomic cooperation.

Managing Severe Sovereign Debt Crises

Severe sovereign debt crises may pose a significant risk to the stability of the global financial system through contagion and spillover effects. Participants pointed to broad dissatisfaction with the status quo of the architecture for addressing issues of sovereign debt solvency and restructuring. While a number of remedies have been proposed, complexities concerning the large size of stakeholders involved in a restructuring, as well as the heterogeneity of their interests, have prevented progress in achieving a broadly acceptable solution.

While a comprehensive multilateral framework supported by both emerging and advanced economies, as well as market participants, would go a long way in addressing current gaps in the status quo, differing views on how to achieve equity and justice, not just economic efficiency, in the management of severe sovereign debt crises make the establishment of such a system an ambitious goal. Incremental steps toward developing a coherent system are therefore essential. The following recommendations ensued from the discussion:

- **Standardized contractual approaches:** As the G20 has supported contractual approaches in recent communiqués,[3] it should seek widespread implementation of new standardized terms in sovereign debt contracts issued in G20 jurisdictions. The latest ICMA standards for collective action clauses and *pari passu* provisions are one obvious case,[4] but the G20 could be more ambitious by promoting the adoption of new best-practice standards[5] and setting a plan to transition outstanding stocks of debt so as to align them with the new standards.
- **Regulate SCDSs:** Although SCDSs are used by many investors to hedge against the risk of default or restructuring, they are also used to speculate on the probability of default. This dual function creates divergent interests among creditors as speculators look to profit off of default while traditional investors prefer to avoid it. These different objectives complicate restructuring negotiations. In effect, SCDSs create an incentive for some debt holders — the speculators — to block restructuring processes in order to force default.[6] Because these assets are exchanged through over-the-counter (OTC) transactions, they cannot be monitored by regulators. The G20 should, thus, work toward banning speculative positions, as has been done in the euro zone, or at least improve transparency by requiring SCDS holders to disclose their positions.
- **Overcoming fragmentation:** Contracts are, by definition, voluntary and subject to interpretation by national courts. Variations from and divergent interpretations of the ICMA model are likely to persist, fuelling fragmentation in sovereign debt restructuring. The fact that some claims on the sovereign are not based on standardized bond contracts and are restructured separately exacerbates the problem. When similarly situated debtors and creditors are treated differently, the system loses efficiency and legitimacy. Ideally, the G20 should promote consensus on an interpretation of standardized contracts, encourage liquidity support during restructuring and support statutory mechanisms to shield a restructuring that proceeds in line with consensus norms from free-rider lawsuits.[7] Contract, statute and international norms should work together to promote comprehensive and fair treatment of all stakeholders.
- **Transparency:** The outcomes and assumptions underlying sovereign debt restructuring should be accessible and intelligible to all stakeholders. Restructuring currently takes place in different fora, none of which are subject to mandatory disclosure requirements. As a result, information about restructuring experience, norms and practices is scarce and disjointed. This makes it difficult to anchor market expectations and achieve fair distribution outcomes that have broad-based support. The G20 should work toward a standardized, systematic and comprehensive public disclosure standard in sovereign debt.[8]

International Financial Regulatory Reform

The G20 has made progress in reforming international financial regulatory standards since the GFC, including establishing the Financial Stability Board (FSB), committing to the implementation of Basel III capital and liquidity rules, and developing standards for regulating OTC derivatives markets, securitization markets and institutional investors. The Turkish G20 presidency has set the goal of finalizing the regulatory

3 Efforts to strengthen debt-restructuring processes through contractual obligations were mentioned in the G20 Leaders' Communiqué at the 2014 Brisbane summit. The issue was also considered by the G20 finance ministers and central bank governors during their meeting in Istanbul in February 2015.

4 See Makoff and Kahn (2015) for a detailed account of the development of the ICMA contractual standards and approaches to facilitating their adoption.

5 For example, state-contingent bonds — including sovereign "cocos" and GDP-linked bonds — detailed by Brooke et al. (2013).

6 For a more thorough account of the effects of SDCSs on debt-restructuring negotiations, see Brooks et al. (2015).

7 See also Brookings-CIEPR (2013).

8 See also United Nations Conference on Trade and Development (2015).

framework as a key priority. In this vein, in April 2015, G20 finance ministers and central bank governors pledged to finalize the establishment of common standards on total loss absorbing capacity (TLAC) for globally systemically important banks (G-SIBs), finalize loss absorbency requirements for globally systemically important insurers and establish a methodology to identify non-bank, non-insurer G-SIFIs. However, the Turkish G20 presidency should not mark an end — or even a slowdown — in reforms because much remains to be done, including: addressing the issues of incomplete information and the complexity of regulation and, most importantly, dealing effectively with TBTF.

A remaining issue is the involvement of EMEs in setting and implementing financial regulatory standards.[9] In particular, it remains unclear whether a "one-size-fits-all" regulatory approach is appropriate, or whether the G20 needs to accommodate different levels of development of financial institutions. Global financial regulatory standards need to be able to prevent regulatory arbitrage, but also acknowledge differences in EMEs. The FSB will deliver a report to the G20 at the Antalya summit on the implementation of the regulatory reforms and their effects, including an analysis of implementation by, and effects of reforms on, EMEs. Key issues affecting EMEs include implementation issues concerning proportionality and sequencing, spillovers from regulatory practices in advanced economies, and home-host cooperation for cross-border institutions. These should be priorities for China, the upcoming chair of the G20, because it has authority in global financial standard setting due to its representation at the main financial standards-setting bodies and because the integration of China's financial sector with the global financial system will eventually accelerate.

The momentum of global financial regulatory reform should be maintained during the Turkish presidency. The following recommendations emerged from the discussion:

- **Implementation and monitoring:** In order to ensure that the agreed-to internationally harmonized financial regulations are effective, the G20 must ensure they are fully and consistently implemented. Building trust among member countries will be crucial to achieving this. One way to establish trust is to cooperate fully with FSB peer reviews. The G20 should also ensure that the FSB addresses constantly evolving risks and vulnerabilities in the global financial system by closing data gaps and sharing analyses.
- **Finalizing TBTF:** Five additional measures are required for the TBTF framework to succeed: higher TLAC requirements than a G-SIB would need within its own jurisdiction; more intensive supervisory oversight for SIFIs; a comprehensive internationally agreed legal and regulatory framework for resolving distressed SIFIs that includes bail-in provisions for private creditors and stakeholders, and respects a consistent ranking of creditor priority; close and effective cooperation within the crisis management groups of home and host country regulators that have recently been established; and a resolution framework consistent with the FSB Key Attributes for Effective Resolution, to ensure that all financial institutions can be resolved safely and quickly, without destabilizing the financial system.
- **Establish a limited multilaterally harmonized cross-border resolution regime:** With respect to the resolution framework mentioned above, the G20 should agree on a concrete timetable to put in place an internationally harmonized resolution regime for large cross-border financial institutions. Although the design of such a framework is already underway, the fundamental problem is to make it politically feasible and operational. A first step in this direction could be to create a limited multilateral agreement for a subgroup of G20 countries. This agreement could include countries that have highly integrated financial systems and are traditionally stronger implementers of international financial standards — including, for instance, Canada, the United States and the United Kingdom. Such an agreement could set the stage for wider adoption in the future.
- **Illicit financial flows:** The Turkish G20 presidency has already committed to issues related to cross-border tax avoidance and corruption by focusing on implementing the Base Erosion and Profit Shifting Project and the 2015-2016 Anti-Corruption Action Plan. To sustain momentum on these issues and champion an agenda that is favourable for emerging market and developing countries, the Turkish presidency should, with the support of the upcoming Chinese presidency, introduce the issue of illicit financial flows as an agenda item.

Addressing Environmental Sustainability Risks through Regulatory Reform

In 2007, the G20 finance ministers and central bank governors stated in their final communiqué that they "discussed the economic implications of climate change…[and] agreed that the G20 can play an important role in this debate" (G20 Finance Ministers and Central Bank Governors 2007). Since then, the G20 has agreed to phase out fossil fuel subsidies, established the G20 Climate Finance Study Group and affirmed its support for the United Nations Framework Convention on Climate

9 For research concerned with methods of including EMEs in global regulatory processes, refer to the group of papers released as part of the CIGI-INET project "New Thinking and the New G20," available at: www.cigionline.org/series/new-thinking-and-new-g20.

Change's (UNFCCC's) Green Climate Fund (GCF). Despite that, however, G20 members have a poor track record on actually following through on these commitments; for example, only 11 of the G20 member states have announced pledges to the GCF and only six of those have actually signed their contributions agreement.[10]

For the most part, the G20's efforts to tackle the issue of climate change have been little more than recognition that it is a problem that needs to be solved. This year, the Turkish presidency has affirmed its commitment to addressing climate change, with a focus on financing for the sustainable development needs of low-income and developing countries. But the G20 can do more.[11] Conference participants made the following recommendations:

- **Pushing the agenda forward in international financial institutions (IFIs):** Participants saw a strong role for the G20 in supporting international organizations in furthering specific objectives and ensuring that they have sufficient capacity and resources to pursue them effectively. Against this background, the G20 should push for environmental sustainability and climate change risks to be prominently featured on the agendas of the IFIs. This issue could be incorporated into IFIs' institutional practices by, for example, integrating risks from climate change and environmental degradation into macroeconomic analysis, and by encouraging IFIs to promote macroeconomic policies among their constituency that help address these risks. By doing so, the G20 would de facto establish environmental sustainability as a prominent global economic issue.
- **Dealing with stranded assets:** In April 2015, G20 finance ministers and central bank governors asked the FSB to convene a public-private inquiry into the effects of stranded assets and other climate change-related issues on financial markets. The impact of climate change on the financial portfolios of banks and other financial institutions is not yet clear. As a first step, the G20 should have its members analyze the risks climate change poses for the stability of their financial institutions.
- **Fossil fuel subsidies:** The G20 should have its members stick to their commitments in effectively ending fossil fuel subsidies to prevent further acquisition and mispricing of fossil fuel assets. In doing so, the G20 should commit to a transparent process by publicly disclosing each member's fossil fuel subsidies and making time-specific commitments to winding them down.
- **Incorporate environmental risks and sustainable development into financial market regulation:** The G20 should analyze whether sustainable development should be incorporated into financial market regulation. This should begin with a commitment to voluntary codes of conduct — for example, the Equator Principles, the UN Environment Programme Financial Initiative and UN Principles for Responsible Investment. Along these lines, the G20 should commission a report by the FSB to determine how financial regulatory policies can help facilitate finance for green energy projects and other projects that utilize or foster more environmentally sustainable practices, while deterring funding for "dirty" projects. As China has already taken the lead in incorporating environmental considerations into financial regulation, the Chinese presidency should provide additional impetus on this key policy item.

Conclusion

With the collapse of the global financial system no longer an immediate concern, it is time for the G20 to move on and address longer-term challenges. Supporting the strength and relevance of the IMF is important to ensure that the world continues to have a common source of analytical support and a common backstop in the event of crises. Taking steps to improve cooperation in financial regulatory standards, cross-border macroeconomic policy analysis and implementation, and debt restructuring processes will go a long way in supporting a more prosperous future by strengthening the stability of the global economy and financial system. Most importantly, the G20 should take the lead in establishing environmental sustainability and climate change risks as the biggest threats to the global economy and financial system. Without taking such steps, no other accomplishments can be successful in securing a prosperous, lasting future.

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10 See GFC "Pledge Tracker," information as of June 3, 2015.

11 Conference participants supported a much broader role for the G20 in addressing climate change. For example, delivering concrete and ambitious goals in support of the UN initiatives (UNFCCC, sustainable development goals and financing for development), and integrating the discussions on long-term investment, infrastructure, development and climate change.

Acronyms

CIGI	Centre for International Governance Innovation
EMEs	emerging market economies
FSB	Financial Stability Board
G20	Group of Twenty
GCF	Green Climate Fund
GFC	global financial crisis
G-SIBs	globally systemically important banks
G-SIFIs	global systemically important financial institutions
ICMA	International Capital Markets Association
IFIs	international financial institutions
IMF	International Monetary Fund
OTC	over-the-counter
SCDSs	sovereign credit default swaps
SDR	Special Drawing Right
SIFIs	systemically important financial institutions
T20	Think 20
TBTF	too big to fail
TEPAV	The Economic Policy Research Foundation of Turkey
TLAC	total loss absorbing capacity
UNFCCC	United Nations Framework Convention on Climate Change
ZLB	zero lower bound

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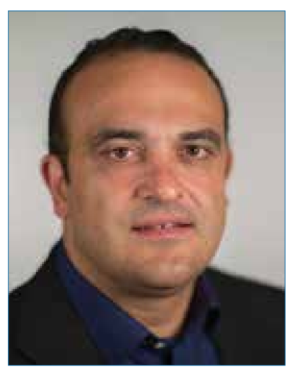

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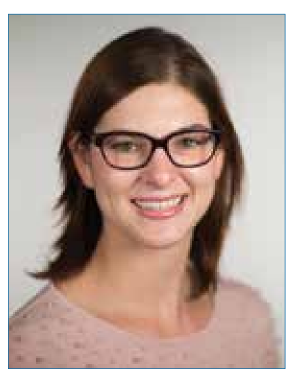

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About CIGI

The Centre for International Governance Innovation is an independent, non-partisan think tank on international governance. Led by experienced practitioners and distinguished academics, CIGI supports research, forms networks, advances policy debate and generates ideas for multilateral governance improvements. Conducting an active agenda of research, events and publications, CIGI's interdisciplinary work includes collaboration with policy, business and academic communities around the world.

CIGI's current research programs focus on three themes: the global economy; global security & politics; and international law.

CIGI was founded in 2001 by Jim Balsillie, then co-CEO of Research In Motion (BlackBerry), and collaborates with and gratefully acknowledges support from a number of strategic partners, in particular the Government of Canada and the Government of Ontario.

Le CIGI a été fondé en 2001 par Jim Balsillie, qui était alors co-chef de la direction de Research In Motion (BlackBerry). Il collabore avec de nombreux partenaires stratégiques et exprime sa reconnaissance du soutien reçu de ceux-ci, notamment de l'appui reçu du gouvernement du Canada et de celui du gouvernement de l'Ontario.

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