

The G-20 Since 2008: Some Reflections on the Experience and the Road Ahead

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1 Introduction: The Emergence of Questions

Four years after the financial crisis of 2008, the global economy is still in a state of fragility. The early signs of recovery, which were seen as a vindication of the coordinated global policy response in late 2008 and early 2009, have not developed into a sustained revival of the growth momentum that the global economy experienced in the years before the crisis. While the global economy grew by about 4.8% per year during the 5 years, between 2003 and 2007, it slowed to about 2.8% in the subsequent 4 years¹. Further, the post-crisis growth pattern was quite skewed, as emerging market economies (EMEs) initially showed relatively greater responsiveness to the policy stimulus. Recently, however, even these economies have slowed, as perhaps might have been expected in a scenario in which the world's major advanced economies simply failed to sustain whatever early momentum they had generated.

Against this broad backdrop, a number of stress points have emerged in the global economy, which can be seen simultaneously as both outcomes and contributors to the macroeconomic situation. From the perspective of the debate and dialogue in the G-20 finance track, two issues had a lot of airtime over the past couple of years. In late 2010, in the wake of enhanced liquidity provisions by the US Federal

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¹ Simple averages of annual growth rates computed from the World Economic Outlook of the International Monetary Fund (various issues).

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Reserve, concerns were raised by some EMEs about the impact that this measure would have on their currencies. It was felt that the appreciation of these currencies would reduce the competitiveness of EMEs for essentially no fault of their own. Then, from early 2011 onwards, the unfolding of the sovereign debt problems in Europe evoked concerns about the adequacy of the policy response to them.

On several other issues, the initial promise of concerted collective action within the G-20 has given way, perhaps expectedly, to a greater articulation of the differences between the members. On the important and long-standing agenda of the framework for strong, sustainable and balanced growth, there has been a degree of convergence of views on the indicators that might be used to gauge potential stress in economies. However, even as this has happened, there are questions about the uniformity of interpretation of individual indicators in clearly different macroeconomic contexts.

On the very ambitious financial regulation agenda, concerns are being expressed about the capacity of different financial systems to absorb the requirements of the new framework, the requirements these will impose on regulatory agencies and the difficulties in bridging wide gaps between national frameworks (which is needed to make progress towards a globally consistent and coordinated regulatory framework). As regards the reform of the international monetary system, aspirations for changes in the quota and governance frameworks in the International Monetary Fund (IMF) are coming up against differences between countries on what specific factors should determine the new quotas.

In terms of both the stress points and the emergence of differences across what might be seen as “permanent” agenda items, an impression might be created that the G-20 process has run its course. After all, the very purpose of this grouping, when it was first created in 1997, was to make the debate on global issues more inclusive by bringing in at least the larger EMEs into it, along with the European Union. The value of this grouping was certainly realized in 2008, when G-20 Leaders met for the first time in Washington DC as Heads of the States. Even though the crisis originated in the advanced economies, the complex interlinkages that had developed between them and the other economies in the group carried massive spillover risks, which were clearly manifested in global economic outcomes during late 2008 and early 2009. Consequently, there was little hope of a global recovery taking place without the direct involvement of the entire group. Moreover, as I indicated earlier, the initial signs did suggest that the strategy worked.

However, subsequent developments, both in terms of economic events and outcomes and in terms of the nature of the debate within the G-20, raise questions about the relevance and utility of the group beyond a forum for sharing and exchanging views on various issues of global significance. Can it regain its stature as a “problem-solving” group, that is able to generate the kind of consensus and follow-up actions that it did during the 2008 crisis; or, is it just a “wartime” grouping that works only when a crisis is at hand, but does not have the framework to be effective in a “peacetime” setting, in which collective solutions to structural problems need to be found?

2 The Rationale for Continuing

In theory, this is a relatively easy question to answer. The basic rationale for a grouping like the G-20 is that it encompasses a set of countries which are strongly interlinked, so that shocks that emanate in one or some of them are almost certain to quickly transmit to the others. In a broader variant of the “no taxation without representation” idiom, the principles of public choice would suggest that it would be in the interest of the overall welfare of the group for each one to have a say in the design and management of shock absorption mechanisms.

Viewed from this perspective, the agenda that the group has set for itself is clearly based on the global public goods nature of each of the items. There are, of course, other global public goods that have resulted in parallel collective mechanisms within which their benefits and costs are distributed. A uniform set of rules for international trade reflected in the World Trade Organization and the ongoing debate on the allocation of responsibilities for mitigation of climate change, as reflected in the United Nations (UN) Framework Convention, are the two primary examples. Clearly, in both these institutions, the representation is much larger than 20, because the implications of inclusion or exclusion are relatively significant for smaller countries.

The specific global public goods that are represented in the G-20 finance track agenda relate to macroeconomic and financial interlinkages. Of course, the question has often been asked as to why the group is confined to the 20, when several other economies also face the threat of disruption from shocks emerging from this group.

The arguments for a small grouping are based on limits to coordination and collective action, particularly in “wartime” situations in which speed and timing are of the essence. These arguments are valid, but do not necessarily indicate a specific number of members as being optimal. Nevertheless, as the emphasis of the group shifted focus from immediate crisis management to addressing the structural factors that were widely seen to have played a role in the financial crisis precipitating and spreading globally, this agenda has effectively become a testing ground for whether a viable solution to this particular global public good can be found.

3 Challenges and Responses

The two issues that I referred to earlier—the spillover from domestic monetary actions in one economy into the real sectors of other economies and the implications of sovereign debt stresses in one group of countries for financial and macroeconomic stability in the rest of the group—highlight the challenges and limitations to a collective, cross-country approach.

As regards the first, the conventional mandate of monetary policy in any country is very clearly confined to, with varying degrees of emphasis, domestic price stability, domestic output stability, domestic financial stability and stability of the cur-

rency. Different countries may choose to assign weights to each of these objectives in their specific policy rules. However, nowhere in this framework does the price, output, financial and currency stability of other countries appear. No central bank is going to be held domestically accountable for the impact that its actions may have on the economic situation of other countries. Yet, diagnoses of the crisis do suggest that a feedback loop between monetary conditions and financial market outcomes in the advanced economies played a role in the international transmission of the crisis. If capital flows relatively smoothly across countries, the monetary policy actions of one, particularly a large, economy is very likely to impact others.

In response to this, rewriting the textbook on monetary policy to take account of spillovers was way beyond reach. What was more practical and within the ambit of the G-20 framework was a consideration of appropriate responses by individual countries to this potentially disruptive force. It was in this context that the issue of the appropriateness of capital controls entered the agenda. The basic framework for this discussion was laid out in a paper published by the Research Department of the IMF, which dealt with the pros and cons of specific types of controls in a given global and domestic macroeconomic environment.

Of course, from the EME's perspective, since the second half of 2011, the situation has actually reversed. What was anticipated as a persistent inflow, reversed direction and, instead of pressures to appreciate, many countries saw their currencies depreciate. Global liquidity conditions still favour a recurrence of inflows, but the state of the global economy now makes all these projections rather tenuous. Notably, the G-20's Coherent Conclusions for the Management of Capital Flows adopted in November 2011 represent a hard-won consensus on broad principles. Taking into account and building upon the G-20's conclusions, with respect to the liberalization and management of capital flows, the IMF brought out the institutional view on capital flow management (CFM, IMF 2012). Perhaps the debate is not yet over and the group needs to revisit the whole issue in a symmetric framework—one that considers both inflow and outflow scenarios. However, from the viewpoint of the agenda for structural change, this is both an important issue and an illustration of how practical considerations have shaped the debate within the group.

The sovereign debt situation in Europe and the risks it poses to global macroeconomic and financial stability has also received much attention in the finance track discussions over the past couple of years. The situation has evolved rapidly over this period, sometimes in a reassuring direction, sometimes not. The role of other countries in contributing resources to support a potential solution is one concrete issue that has emerged against this backdrop, particularly with reference to the enhancement of the IMF's resource base. More generally, one could, of course, take the view that Europe will create a combination of institutions, incentives and resources that will address the problem. Alternatively, one could argue that this convergence to a solution has been speeded up and facilitated by encouragement from the other countries in the group, who are quite conscious of the likely impact of a failure to resolve the issue on their own economies.

4 The Agenda for Structural Change: A Look Forward

As we look beyond these issues to the larger agenda for structural change, the general question that arises is the effectiveness of the processes by which a broad consensus is arrived at, or, conversely, when an issue is deemed too contentious to remain on the agenda. The G-20 has followed a Working Group approach, which allows individual members the time and space to articulate their positions on various issues within each group's domain. In turn, this allows subsets of countries, whose positions are relatively closer to each other on specific issues to converge more quickly and articulate mutually acceptable common positions.

Having referred to the "wartime" vs. "peacetime" distinction a little earlier, I want to re-emphasize its importance in understanding the sustainability of a collective process that is addressing structural issues. A basic insight of cooperative game theory, which is a framework through which all these multilateral mechanisms can be usefully viewed, is the ability of individual players to improve their outcomes by forming credible coalitions. Therefore, it is in every country's interest to seek out others whose positions are closest to theirs.

In this context, the basic distinction between "wartime" and "peacetime" conditions is that in the former, a single coalition encompassing all the members of the group is viable, because the threat is universal and the costs of not responding adequately fall on the entire group. By contrast, in "peacetime" situations, in which structural changes are being discussed, a single coalition is quite unlikely. The process is more likely to move forward in a stepwise fashion, as smaller coalitions are formed around proximate positions. Given the relatively large number of issues involved, even in the finance track alone, the number of possible coalitions and the membership of each country in multiple coalitions obviously raise concerns about the sheer complexity of the process. However, it is really the responsibility of the working groups, complemented by events like the one in which this speech is being delivered, to address these complexities and narrow down the distance between positions as much as possible.

5 The Indian Perspective on the Current Finance Track Agenda

The programme for this seminar is built around the finance track agenda, although some of the sessions have been designed to take a somewhat broader view of the issues covered. The seminar is also intended as a forum for participants to present and discuss country perspectives on the agenda items. I would like to begin the process with some brief thoughts on three issues that are a very important part of the finance track agenda in the foreseeable future, with a view on illustrating how global concerns need to be viewed in a domestic context to arrive at meaningful positions.

5.1 On the Framework for Strong, Sustainable and Balanced Growth

The progress on this front, coordinated by a working group co-chaired by Canada and India, has been quite significant. Arriving at a compact set of indicators that might provide early warnings of the build-up of stress in either financial markets or the real economy was clearly a very complicated task. The patterns manifested by various indicators during the crisis provided a useful context; but one episode, or even a small number of them, can hardly be expected to yield a robust and comprehensive early warning framework. Apart from this, perhaps the more challenging issue for this agenda has been to deal with multiple interpretations of a particular indicator, given the specific circumstances of countries.

From India's perspective, two indicators have been important. One, India has a relatively large trade deficit, which is of course moderated by a significant surplus on the invisibles account. If the framework were to look at the size of the trade deficit as an indicator of stress, the inference could be quite different than if the focus were on the current account deficit. Two, rapid growth in bank credit is typically viewed as a sign of potential financial instability, but in an economy in which access to the organized financial system is itself increasing on a trend, the need to distinguish between structural and cyclical components of credit growth is important if it is to be used as a stress indicator.

5.2 On the International Financial Architecture and Global Financial Safety Nets

The global economy is fundamentally more interconnected than ever before. The recent financial crisis showed that even those countries with sound policies could be affected by global shocks and thereby highlighted the need to strengthen the global financial safety nets. Therefore, after the crisis, the shortage of liquidity occupied the centre stage of discussion. It was generally felt that the existing liquidity-providing mechanisms were ineffective in handling crisis prevention and crisis resolution. In this context, the issues of augmenting international liquidity, enhancing IMF resources and improving the efficiency of IMF instruments of lending were brought to the fore. India's stance was that IMF should remain a quota-based institution. Therefore, the 14th general review of the quota should be ratified by all the member countries at the earliest with the immediate commencement of quota formula review exercise for the 15th general review.

India has suggested a three-pillar mechanism for global financial safety nets. We have been in favour of a diversified global financial safety net consisting of reserves as the first line of defence (Pillar I). Sound economic policies, effective prudential regulation and an appropriate level of reserves are regarded as the primary lines of

defence. It is important to remember that self-insurance gives automaticity, fungibility and usability in crisis prevention and crisis resolution.

Regional financing arrangements and currency swap arrangements also have the potential to meet eventualities, and such initiatives should be promoted (Pillar II). Any safety net should be supported by co-financing arrangements with international financial institutions, which have been very active recently.

As regards enhancement of IMF resources, India has argued that the IMF is a quota-based institution and it should remain one. In this context, we emphasized the importance of early ratification of 2010 quota increases (14th Review) as well as the quota formula and governance reforms. We had committed to contribute US\$ 10 billion under NPA which folded into our NAB commitment of US\$ 14 billion. In addition, we have now committed US\$ 10 billion under the 2012 borrowing arrangement.

In its efforts to address the issue of global imbalances, the IMF was asked to assess the reserve accumulation of large reserve-holding countries. It came out with a reserves adequacy matrix, which is now built into the integrated surveillance decision where external balance assessment is an important element. In this assessment, China, India, Brazil, Russia and Thailand are judged to have excess reserves (IMF 2011). The IMF favours lower maintenance of reserves on the grounds that building of excess reserves in some EMEs is leading to global imbalances.

India's stance on this issue is that reserves should be seen as a part of a diversified global financial safety net approach with reserves and strong fundamentals as the first line of defence. While evaluating the level of reserves and the quantum of self-insurance between countries, a distinction needs to be made between countries whose reserves are a consequence of current account surpluses and countries with current account deficits whose reserves are a result of capital inflows in excess of their economy's absorptive capacity. India falls in the latter category. Our reserves comprise essentially borrowed resources, and we are therefore more vulnerable to sudden stops and reversals as compared with countries with current account surpluses.

Developing a reserve adequacy formula in the face of volatile capital flows and fluctuating commodity prices is a highly debatable issue. Reserves will necessarily remain the primary line of defence against any eventuality in future. It may not be advisable to restrict the level of reserves by instituting subjective formula. Country-specific circumstances need to be given due recognition.

5.3 On Prudential Regulation and the Basel Framework

On the issue of prudential regulation, the G-20 commitment is to implement fully and consistently the Basel II risk-based framework as well as the Basel II.5 enhanced requirements on market activities; and securitization by end of 2011 and the Basel III capital and liquidity standards, as per the phase-in arrangements, and

review clauses, starting in 2013 and completing full implementation by January 1, 2019.

As far as India is concerned, the Reserve Bank of India announced the draft guidelines for Indian banks under Basel III on December 30, 2011 and the final guidelines on Basel III capital regulations were issued on May 2, 2012. Basel III is being implemented from April 1, 2013² in a phased manner. Banks are expected to start disclosing Basel III capital ratios from the quarter ending June 30, 2013. The Basel III capital ratios will be fully implemented as on March 31, 2018. The Indian banks' current capital base and liquidity position are broadly compliant with the Basel III guidelines. Both the capital to risk weighted assets ratio (CRAR) and the core CRAR of Indian banks at 13.8% and 10.3% as of end of March 2013, respectively, remained well above the regulatory requirements of 9% and 6%, respectively under Basel II. Leverage ratios were around 5% as against the Basel III requirements of a minimum of 3%.

Thus, Indian banks start from a position of strength in the process of transition to the Basel III regime, but many challenges lie ahead. For example, raising fresh capital to meet the higher capital requirements under Basel III may pose some challenges especially under an environment characterized by moderating growth and adverse financing conditions. In this context, how the global and domestic economic situations evolve in the coming years will be very important. A quick and sustained turnaround in the global economy will support India's growth momentum by improving both external demand and the overall investment climate. This will, in turn, improve private savings as well as government finances, auguring well for additional capital mobilization for banks in India.

The status report on the implementation of Basel II and Basel III, published by the Basel Committee on Banking Supervision (BCBS) in April (2012), observed that some countries, especially the advanced economies, need to expedite the process of implementation of Basel III in a time-bound manner. In the BCBS assessment of the rules for the European Union and the USA, some gaps have been identified which need to be plugged. We feel that the emerging economies should not be seen as front-runners in the Basel III implementation process.

6 Concluding Thoughts

I have tried to look at the G-20 process, using the finance track agenda to illustrate my arguments, through two conceptual lenses: the global public good nature of the agenda items, and the role of coalitions between subsets of countries in order to move the agenda forward. The first perspective underlines the need to continue with the process beyond the immediate compulsions of crisis response, based on the recognition that the agenda for structural change also has significant public good

² The start date for implementation was rescheduled to April 1, 2013 from January 1, 2013 to align the implementation date with the financial year (which begins from April 1 each year).

characteristics, which make it necessary for countries to participate in a collective process of coordinated change.

The second focuses on the need to take a realistic view of a process, which has shifted focus from crisis management (wartime) to structural change (peacetime). The ease with which consensus across the group—a single coalition—can be found in wartime is not going to be replicated in peacetime. The way forward, then, is for countries whose positions on individual issues are close to each other to look for convergence and to present a united view to the larger group. This is perhaps a way to either more efficiently reach a broader consensus or decide that this is difficult to achieve on certain issues.

Since, this is a seminar that provides an opportunity for different country perspectives on a series of finance track issues to be articulated; I also tried to present some flavour of the thinking that is going on behind Indian positions on some critical issues, to illustrate the way in which global issues and concerns need to be viewed in a country-specific context in order to arrive at meaningful positions.

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