

Three Years of The G-20: An Assessment

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When the G-20 leaders meet at Cannes in November, it will be three years since their first meeting in Washington, at the height of the 2008 crisis. They can claim significant achievements in this period, notably the containment of the worst global crisis since the great Depression and also the start of some new initiatives such as the coordination of macro-economic policies, and the evolution of an appropriate structure for financial regulation, though these remain works-in-progress. However, the Eurozone crisis, added to the vulnerabilities of the last three years, presents new challenge which will once again test the effectiveness of the Group in crisis management.

Most would agree that the G-20 did well in orchestrating a simultaneous fiscal expansion by all countries with supportive monetary and financial policies globally to contain the crisis of 2008. There was a contraction in the industrialised countries in 2009, but they returned to positive growth in 2010 and the emerging market countries performed strongly in both years, indicating the emergence of a potential new source of dynamism in the world economy. The turnaround was also supported by the G 20 decision to expand financial resources for the IFIs, strengthening the global safety net and stabilising market confidence. The voting share of dynamic emerging market countries in the IMF was increased, less than might have been warranted, but clearly a move in the right direction. Significant progress was also made in outlining an action plan for reform of the architecture for financial regulation to deal with risk and instability. The Financial Stability Forum (FSF) was expanded to include all G-20 members and renamed the Financial Stability Board (FSB) as a permanent institution for overseeing the activities of international standard setters and facilitating consultation with national supervisory authorities and the IMF.

The G-20 also launched an ambitious effort at multilateral policy coordination – the Mutual Assessment Process (MAP) – aimed at coordinating macro-economic policies among the major countries of resuming sustainable growth. Coordination was viewed as critical for sustaining growth and reassuring markets. The crisis had led to a sharp increase in the sovereign debt position of industrialised countries in large part due to the collapse in government revenues and the increase in expenditure on the social safety net. While the resulting fiscal stimulus proved effective in supporting economic activity temporarily, it was obvious that it would have to be reversed. Since such a reversal would have a contractionary effect on economic activity, it was felt that the reversal should be phased to avoid an immediate contraction while simultaneously seeking to reassure markets by taking credible steps to ensure fiscal viability over the medium term. This strategy needed to be supported by rebalancing of global demand, with an expansion of demand in surplus countries, accompanied by greater exchange rate flexibility. Coordinating macro-economic policies on this scale among sovereign governments is not an easy task. Earlier IMF efforts had proved unsuccessful, but it was hoped that the MAP, being a country led process would do better. The Cannes Summit was expected to be the first opportunity to review, and hopefully agree

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upon the outcome of the MAP process in terms of a consistent set of policies for individual G-20 countries capable of restoring growth.

All this has been overtaken by the explosion of the sovereign debt crisis in the Eurozone, which if not effectively controlled could have a major destabilising effect on Europe and, given the weight of Europe and its integration with the rest of the world, therefore also on the global economy. The crisis was triggered by the collapse of the rescue package for Greece which put pressure on Ireland and Portugal, with contagion spreading to Spain and even Italy. All these countries have serious debt problems, though none as serious as Greece. Unfortunately, the failure of the IMF package for Greece has eroded market confidence, making it difficult to prevent the spread of contagion.

Greece is now widely regarded as “insolvent” in the sense that the maximum austerity that is socially and politically acceptable will not allow Greece to reduce its debt to GDP ratio to acceptable levels, given the low growth prospects facing the Greek economy. The low growth potential in part reflects both weak underlying factors such as low investment and the fact that domestic austerity will itself reduce domestic demand and depress economic activity. There is little prospect for offsetting this contractionary effect by relying on external demand given the absence of exchange rate depreciation as a policy option and also the depressed state of the European and world economy.

For all these reasons, markets believe that Greece can be rescued only if there is a substantial debt reduction. The July 21 package agreed with European leaders did involve some reduction of Greek debt, *via* a restructuring package backed by the EFSF, but it was much less than was needed. Current market sentiment suggests that a haircut of between 40 and 50 percent of bank debt would be needed and it remains to be seen whether such an outcome can be agreed and how the burden will be shared: should it be borne largely by the banks themselves, that lent imprudently to begin with, or be shared by the ECB or the EFSF? Of course, if the banks take a hit it will be left to governments to recapitalise the banks further eroding their weak fiscal positions.

The build up of sovereign debt in Greece and other countries of the periphery reflects a variety of factors including weak growth, lax fiscal policies, and imprudent bank lending arising, the last arising from a failure to recognise some inherent weaknesses in the Eurozone. The adoption of a common currency removed the currency risk from lending to countries within the Eurozone, which legitimately should have led to somewhat lower interest rates. However, European banks behaved as if credit risk had also been eliminated and fiscally weak sovereigns were able to borrow at interest rates only marginally higher than Germany. This would have been reasonable if the Eurozone had mechanisms which actually enforced fiscal prudence, but there were none. Such mechanism that existed has been breached earlier and made irrelevant. Despite this, the banks lent excessively, leading to a large build up of sovereign debt in the countries that are now in trouble.

The Summit at Cannes faces two major challenges in addition to the normal items on the agenda. First, and most immediately, it is necessary to reassure markets that credible steps have been taken to ensure stability in the Eurozone. Second, having ensured stability, the Summit also needs to show some progress on the MAP. The two are obviously connected since progress on the MAP should allow higher levels of growth for the world economy, and therefore also for the debt stressed countries, which in turn will impact favourably on any assessment of debt sustainability.

Stabilisation of the Eurozone requires most urgently a package which ends the Greek crisis which requires early agreement on the difficult issues listed above. This must be followed by an effective adjustment programme for each country under threat. Even if an objectively credible package is put in place for each country, it may not reassure markets immediately, posing serious liquidity problems so these countries will need liquidity support. This is reasonable - once solvency is taken care of, liquidity must be provided and in ample measure. If the resources needed to meet liquidity needs are to come from the Eurozone itself (whether the ECB or the EFSF) the international community is not directly concerned, although it is vitally interested in the success of the measures. If the Eurozone effort needs to be further backstopped by the IMF, as is very likely, the G-20 is directly concerned. In that event it will be the responsibility of the IMF to determine whether the programme being supported is credible. In effect, the IMF will have to certify whether 'a haircut' is necessary and if so whether it is adequately provided. There is also the issue of what the appropriate scale of the IMF's contribution should be relative to what should be done internally by the Eurozone. More generally, these issues raise the question whether resources available within the Eurozone are adequate, and also whether the resources available with the IMF are adequate. Markets will look for clear signals from the G-20 on all these issues if normalcy can be restored.

Once the immediate task of restoring stability in the Eurozone is assured, the G-20 will still need to make progress on the MAP if only to persuade markets that the macro economic policies being followed by the major countries are consistent with stimulating and sustaining robust growth in the medium term. As pointed out above, creating credibility about growth prospects is itself critical for reassuring markets that debt sustainability issues can be resolved.

All in all, the G-20 will have a lot on their plate in Cannes as they enter their fourth year. It illustrates the proposition that in a globally integrated world, global coordination among major countries is certainly needed. The G-20 is the only mechanism we have to bring this about.
