

Issues & Ideas

G-20 Summit Just a Down Payment

By Bruce Stokes

■ Reforming the world financial system is likely to take years, not months.

■ Europeans are angry over what they see as America's "cowboy capitalism."

■ The G-20 is likely to turn to informal networks of countries and regulators to follow through on proposed reforms.

BRUSSELS—Concern is rising here that Europe may be the principal victim of the spreading global recession. European leaders feel a profound sense of urgency to move quickly in a concerted international fashion to mitigate the worst effects of this downturn and to make sure it never happens again. "Unlike in the United States," said a European Union official, "the attitude here is, we don't want to wait until the dust settles."

Animated by such fears, French President Nicolas Sarkozy and British Prime Minister Gordon Brown prevailed on President Bush to convene a financial summit in Washington on November 15.

The Europeans have grandiloquently dubbed this meeting Bretton Woods II, after the 1944 gathering that created the International Monetary Fund and the World Bank. But this confab promises to be political theater on a global stage conducted largely for home consumption.

Sarkozy is determined to demonstrate that he is the natural leader of a united Europe. Brown wants to resurrect his political fortunes before facing his electorate within the next 20 months. And Bush wants to demonstrate that he is not a lame duck.

This political kabuki overshadows substantive differences over how to proceed with reform of the international financial system. "The French want to regulate everything that moves," quipped Simon Johnson, a professor of economics at the Massachusetts Institute of Technology. "The British want light regulation that does not threaten the future of 'The City.' And the Germans are still in shock."

The Bush administration, for its part, acknowledges the need for enhanced regulation of banks and other financial institutions. But it wants to proceed cautiously, fearful of curbing needed international capital flows and hamstringing financial innovation.

"Quick resolution of the global financial crisis is unlikely to emerge from these deliberations," predicted Harald Malmgren, a Washington-based international financial consultant. "This is a process that will take two to three years, not two to three months."

Nevertheless, administration officials defend the summit as a means of focusing and energizing ongoing responses to the economic crisis. "A lot of coordination has been done already, but not given high-level political attention," said a senior administration official who asked not to be named. "Leaders can bring a sense of urgency to the task."

The summit is expected to commit to a set of financial reform principles; to task various groups to come up with specific recommendations to enhance financial-market transparency, regulation, and oversight; and to deepen participation in international financial institutions. And

■ Forged in Crisis



■ The G-20 was formed in 1997 during the Asian financial crisis; together the members account for more than four-fifths of the world economy.

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the leaders are expected to promise to reconvene in the first quarter of 2009 to review economic conditions and to bless ongoing reform efforts.

The summit will dodge the more-profound and -divisive issues, such as how to mobilize the vast sums of capital needed to bail out developing countries that are struggling and how to reapportion power in the international financial system.

Yet for all of the hyperbole that has preceded this summit and despite its anticipated shortcomings, the recent election of Barack Obama as the next U.S. president has sparked hope in Europe. "With Obama, there will be a new time of seriousness in world affairs," predicted Nicolas Veron, a resident scholar at Bruegel, an economic think tank in Brussels. "If he plays it well, his leadership could be incredible."

The case for urgency is compelling. The IMF projects global economic growth to slow from 5.1 percent in 2006 to 2.2 percent in 2009. Advanced economies' collective growth rate could actually shrink by a quarter of a percent. And China may be headed for a hard landing. European, Japanese, and U.S. banks have lent emerging markets nearly half a trillion dollars, with about three-quarters of that money coming from Western European banks. "If Hungary were to default on its financial obligations, Austria's banks would soon collapse," warned David Smick, author of the new book *The World Is Curved: Hidden Dangers to the World Economy*. "If that happened, Germany's banks might well follow suit."

Malmgren added: "Without other, additional sources of emergency relief, banks and other private lenders to these countries will potentially face writedowns on a much larger scale than the writedowns related to the ongoing real estate downside in the U.S. and Europe."

Little wonder that European leaders have demanded a summit.

The invocation of Bretton Woods by Sarkozy and Brown demonstrated politicians' penchant for bumper-sticker slogans. But the analogy breaks down quickly. The original Bretton Woods conference took two years to prepare and met for 22 days. The November financial summit in Washington was put together in a matter of weeks and was scheduled to last for four hours. It risks having much more

in common with a summit convened in London in 1933 to deal with the global Depression. That meeting failed for lack of preparation.

The 20 national leaders and their finance ministers invited to Washington this month are known collectively as the G-20, a group created during the 1997 Asian financial crisis. They are from Brazil, China, France, Germany, India, Japan, the United Kingdom, and the United States, among other places. Together, their countries account for more than four-fifths of the world economy.

■ Euroleaders



■ French President Nicolas Sarkozy (left) and British Prime Minister Gordon Brown pushed President Bush to call the summit.

The leaders come to the meeting ostensibly reading from the same playbook. The Europeans had agreed on a common set of principles: No financial institution or financial product should be free of supervision and regulation; greater financial accountability and transparency are needed to curtail excessive risk-taking; accounting standards need reform; large banks and other financial groups should be monitored collectively by supervisors from the countries in which they operate; and the IMF should provide a better early-warning system in financial crises.

The Bush administration shares these goals. "The United States has long been committed to needed reform of the financial system, to enhanced cooperation,

and, where appropriate, the establishment of common standards," the administration official said. The United States supports aligning accounting standards, best-practices for private investors such as hedge funds, and enhanced regulation of financial instruments such as credit default swaps and over-the-counter derivatives. And Washington backs strengthening the IMF.

The summit will direct various groups to come up with recommendations to implement these principles and to report back to the leaders' at their next meeting early next year. The U.K. will chair the G-20 next year, so an April summit in London is a possibility, around the time that Obama is expected to travel to Europe to celebrate NATO's 60th anniversary.

But this public comity thinly veils internal G-20 differences that will bedevil Obama's efforts to forge international consensus. "There is a lot of anger in Europe against what they perceive to be American cowboy capitalism," Smick said. "If they had their way, they would completely neuter the American financial sector."

The summit will probably duck many contentious issues. Europe's desire for transparency and limitations on hedge funds, for example, looks to many Americans like an effort to curtail an industry in which America has a competitive advantage. Nor is there agreement on a single regulator of global financial markets. London and New York want to preserve their competitive advantages as world financial centers by operating under their own rules.

And the major players cannot even agree on national reforms. Washington has yet to decide whether it should merge the Commodity Futures Trading Commission with the Securities and Exchange Commission. Similarly, said Karel Lannoo, chief executive of the Center for European Policy Studies here, "there is a need for a European system of financial supervisors, a need for a European bailout fund, and European financial product harmonization."

Also lacking is any support for coordinating national spending plans to prime the world economic pump. Morris Goldstein, a senior fellow at the Peterson Institute for International Economics in Washington,

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has suggested that each G-20 country spend up to 2 percent of its GDP to stimulate growth. But the proposed Democratic stimulus package for the United States would equal only about 1 percent of America's GDP. And a recent German stimulus package totals only 0.5 percent of GDP in fresh outlays. Furthermore, only about a third of the recently announced Chinese stimulus package actually represents new money.

And pledges of fealty to the IMF cannot hide differences over the institution's future role, funding sources, and governance. "The financial crisis has put an end to existential questioning about the future of the Fund," said Jean Pisani-Ferry, Bruegel's director. The IMF has recently provided money for troubled treasuries in Hungary, Iceland, and Ukraine. There is also general international agreement on the IMF's future role as an intellectual resource and as the possible secretariat for global regulatory cooperation.

But, Pisani-Ferry said, "it is unlikely to recapture the central role it once had." There is no agreement, for example, on the IMF's becoming the global financial regulator. Moreover, said MIT's Johnson, "the big issue the summit should address but won't is how much money there is to support the IMF in an emergency." The Fund now has no more than \$250 billion available to lend. "If you have an emerging-market collapse," Smick said, "everybody knows that is not enough."

Brown has called for "substantial additional resources" for the IMF. The Bush administration contends that IMF funds are adequate for the present, but it is willing to look at future resource needs. Yet, how much more is enough? Johnson suggests: "A trillion dollars would send the right signal. A couple of hundred billion dollars would be fine. But I don't think \$50 billion is enough."

The IMF's rules allow it to borrow from private capital markets. It could also increase the amount of money each member country must keep on deposit at the IMF. The Fund hasn't raised this quota since 1998, when the world economy was half its present size. A 50 percent quota increase would yield about \$100 billion in additional resources. And, recommends Ted Truman, another senior fellow at the Peterson Institute, the IMF could also issue more Special Drawing Rights, an asset designed to supplement gold and currencies as a financial reserve. Rich nations could then lend

their SDRs to the IMF to pass on to countries in financial distress, restoring some confidence in the world economy.

Increasingly, the world will also have to look to the countries with huge foreign currency reserves to cough up more cash. China has \$2 trillion in foreign reserves. Japan has \$1 trillion. And Saudi Arabia has close to \$500 billion. These pots of money need to be more readily available for lending in a crisis. But, warned Eswar Prasad, a professor of economics at Cornell University, "both the Chinese and Saudis are not going to be willing to take on increased responsibility unless they have more influence."

The Europeans, whose voting strength in the IMF and World Bank far exceeds their role in the world economy, have long been unwilling to cede a share of their institutional power to developing economies. And, Malmgren warned, "if a U.S. president were to agree to international reforms which in any way restricted the U.S. freedom of action, such an agreement would be rejected by the Congress."

But even if some formula can be found to fudge the issue of control within the international financial institutions, analysts expect that Beijing would want Washington to back off demands for a stronger yuan and that Riyadh would want some floor on oil prices before the Saudis would agree to share their wealth.

Another problem is that no plans have

surfaced to address the current-account imbalances that have emerged in the world over the past few decades as some countries run constant trade and financial deficits and others run surpluses. These imbalances reflect profound national differences in savings and investment patterns that are hard to alter. Pisani-Ferry acknowledged, "The conditions are not there to get big countries to subject themselves to discipline."

Faced with these financial and power-sharing constraints, the G-20 is likely to turn to or create informal networks of countries and financial regulators to follow through on many of the proposed reforms. The model will be the Financial Stability Forum, an international group of major central bankers and financial-sector regulators. U.S. members of the forum are the Treasury, the SEC, and the Federal Reserve.

"The FSF is nothing but an ectoplasm," Pisani-Ferry said. "It has no legal status, no structure, no power, and no staff, yet it has become the core institution where the agenda for financial regulators in the advanced countries is set." The forum's effectiveness derives from its informality and the fact that governments are willing to cooperate within it without any formal ceding of power.

This network-of-networks approach is the future of international problem-solving, contends Ann-Marie Slaughter, dean of the Woodrow Wilson School of Public and International Affairs at Princeton University. The challenge, she says, "is to figure out how to give these networks a more active role in supervising the global economy."

So the November financial powwow is likely to leave a great deal undone. "We see this summit as the first in a series of leaders' meetings," acknowledged the administration official, "as part of a process rather than a one-off gathering." And whether history will judge this summit as the beginning of Bretton Woods II or a modern replay of the failed 1933 London financial summit may depend on the actions of President-elect Obama. Divisions in Europe and the diverse interests of the cash-rich economies suggest that reform won't happen without strong U.S. leadership. ■

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