Challenges ahead for G-20

The second G-20 summit in London has generated high expectations from a world that is becoming increasingly anxious about the length and depth of the on-going global recession. The mood in Europe, where I was last week, and in North America is deeply somber as people expect the economic news to get worse before it gets better. The nightmare, scenario is of the US remaining trapped in a Japan like L shaped recovery that engenders a prolonged recession and rising unemployment in OECD economies and a sharp slowdown in emerging economies. This could trigger competitive protectionism, which if it comes to pass would surely see the world economy plunging into a depression. Therefore, the immediate and most urgent challenge before the leaders in London is to prevent such a nightmare scenario from being played out. The necessary condition for meeting this challenge is to recognize that it is dangerous at this time to pursue narrowly defined national interest. Instead the G-20, acting cooperatively, have to forge a global agenda for pulling the world back from the edge of the chasm of depression with all the associated unimaginable uncertainty and human suffering.

For the G-20 to achieve a common objective and purpose, two institutional advances are required. First, that the grouping should now be given a formal status with the members agreeing to its final composition and giving it a permanent secretariat. At present, even the composition of the G-20 is fluid with members and invitees being added virtually at the discretion of the hosting country. This neither inspires confidence nor lends credibility to the formation. Second, there still exist sub-groups within the G-20 which meet at the sidelines and come up with their own mini-communiqués and declarations. This fosters the ‘Us and Them’ environment that is surely not conducive to collective resolve and action. So G-20 member countries should agree to give up their membership of other groupings. One of the more important implications of this move will be the disbanding of the G-7, which is seen as an anachronism both in European and American academic circles. Let us hope that G-7 leaders will announce in London that the next meeting of the G-7 to be hosted by Italy will be its last. This will be the needed unambiguous signal from developed economies that they are serious about expanding the high table for global governance.

The leaders will do well to focus attention principally on setting the global financial house in order by agreeing to some concrete actions with a time bound plan for implementation. This is the root cause of the present economic distress and any future global economic recovery is critically premised upon restoring the financial sector back to normalcy. This will require that the leaders agree to implement some immediate measures to unfreeze the financial markets and get credit moving again. Some of the actions that can be agreed to are: first, to bring all financial agents under some form of national regulatory oversight that is comprehensive in nature. This will eliminate the ‘shadow financial sector,’ which because of its extraordinarily high leverage ratios and transactional opacity, was at the root of the recent financial sector meltdown. Second, there has to be agreement that that given the huge complexity and heterogeneity of the financial systems and of financial transactions across countries, a global financial super regulator is simply not feasible. Mr. Sarkozy, having apparently been advised by Joseph Stiglitz, feels strongly on this issue. But he should recognize that such an insistence will at this stage only distract from the main task at hand and generate dissonance when least required. I hope there will be agreement on national regulation on the basis of some universally agreed standards and norms, which is the practical solution at this time. Third, the leaders should agree that the present regulatory regime that assures a 'level playing field' for all the players in the financial sector needs to be replaced with a regulation that creates a set of incentives that lead to risk being allocated to where there is a risk bearing capacity. For instance, institutions with a capacity for diversifying risks across time, would not have to put aside reserves/capital/margins for illiquid assets, while institutions without long-term funding or liabilities would have to.

Finally, it will look too much like business as usual if the only tangible decision emerging from the London Summit is to increase the IMF capital base to $500 billion without any reform of the institution, which was being seen as redundant and was down-sizing its staff less than a year ago. Therefore, it should be agreed the IMF should be reformed before its capital base is further enlarged. These reforms would include: getting some visible distance between the IMF and the treasuries of some OECD economies. Making it a more broad based institution both in terms of selecting it top management and the professionals who work there. These two steps will make the Fund a more representative, legitimate and credible organization. The move to enlarging the voice and representation of emerging economies should not await the change in IMF quotas. Instead a system can be designed on the lines of the WTO where major countries come together informally to discuss the major issues and then take their consensus to the broader membership. A criteria that includes both the country's share in the global economy/trade and its share in the global population may be used to determine its quota in the IMF. This alone may provide the basis for achieving a desirable 'voice and representation' structure.