



# **Governance & Development: Views from G20 Countries**

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**The G20 and the dilemma of asymmetric sovereignty.  
Why multilateralism is failing in crisis prevention**

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# **The G20 and the dilemma of asymmetric sovereignty. Why multilateralism is failing in crisis prevention**

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*Abstract: The G20 is not able to move forward with reforms necessary to prevent future financial crises. Successes as in crisis management cannot be transformed into joint crisis prevention. The global regulation of financial markets, agreed upon at previous G20 summits, was intended to make the international financial system more stable and more resilient against future crises. Alas, the resultant expectations were unfulfilled. Likewise, we cannot expect meaningful steps towards a reinforcement of the global regulation of financial markets from this year's G20 summit in St. Petersburg. At least as serious are the failure of the Doha Round and the incapability of the G20 to prevent it, despite the frequently voiced commitment to a multilateral order. The structural crisis in global regulation of today is not least the result of an asymmetric sovereignty in financial politics: States possess only marginal influence on international financial markets, but they are liable in times of crisis. The result is a re-nationalization of financial policies. At the same time, the increasingly critical perception of globalization, in particular in OECD societies, complicates the further evolution of the multilateral trade order.*

Supranational regulation of a range of issues has been on the agenda of international politics for more than two decades. "Global Governance", particularly in economic affairs, was considered a promising concept. The development of shared norms and standards in finance should have helped to reduce risks and prevent future crises. This concept is embodied in the foundation of the Group of 20 in 1999 as a reaction to the financial crises of the late 1990s.

While at in the beginning limited to the finance ministers, the G20 first met at the level of heads of state and government in November 2008. This was deemed a breakthrough by some observers: Finally the problems of increasingly interdependent economies would have been solved at the global level.

### **The crisis management of the G20 was raising hopes**

Initially, the G20 fulfilled the expectations. The global economic and financial crisis was managed without a relapse to protectionist trade policies or harmful competitive devaluations. In the years 2008 to 2011, the G20 was able to implement some significant steps, for example in the modernization of the International Monetary Fund. At the G20

summit before last in Cannes in November 2011 the development of shared rules for the financial markets was still high on the agenda. But only non-binding memoranda of understanding were agreed upon.

In the following two years since the G20 summit in Cannes, some countries have chosen to go their own way and it has become evident that there will be no joint approach to the regulation of financial markets. Notably the U.S. has not only enacted unilateral reforms of its financial markets but has also given up one of the established pillars of financial regulation. Authorities in the United States no longer accept the so called home country principle and have shifted unilaterally to the host country principle, according to which banks operating in the U.S. must also hold capital in the U.S. The U.S. terminates the former consensus of the OECD countries by implementing the host country principle in banking supervision: Financial institutions are being supervised where they operate, not in the country where their headquarters are located. This has far-reaching consequences and will lead to a segmentation of markets. In the future, Deutsche Bank for instance will have to hold capital in New York for its American business – rather than in Frankfurt as was the case up now.

Just like the U.S., ever more countries choose individual national paths for their financial policies. For example, right from the beginning of the crisis, Brazil had raised a tax on capital inflows at rates of 2 to 6 percent and has only abandoned this measure on June 5, 2013 – due to a considerable drop of the Brazilian Real's exchange rate. Switzerland has chosen special capital requirements of its two large banks UBS and Credit Suisse, thereby deviating strongly from the standards of the Basel Committee of Banking Supervision. While large banks have to hold 13 percent capital by the end of the current decade, according to the set of measures known as Basel III, the Swiss banking supervision has enforced much higher capital requirements and is demanding 19 percent of risk-weighted assets from its two largest banks.

### **Liability in the event of a crisis**

What is the reason for this development? Why do countries seem to lose faith in multilateral approaches, not only, but also in the regulation of financial markets? One

important aspect is the largely dissimilar experience with financial crises. For the societies of countries with very large financial sectors – Switzerland, but also Great Britain – the crisis of the years 2008 and 2009 was a traumatic experience, which the affected societies do not wish to repeat. The fiercer the crisis and the closer the abyss, the stronger is the willingness of these societies not to settle at a global minimal consensus in financial regulation.

Of course, a set of rules for financial markets in particular is not only about the implementation of internationally agreed upon regulations, but also about the liability for adverse developments. In the event of a crisis, governments are at least partly responsible for the mistakes of their banks. The crises of the last years have shown this very clearly. Whether in Ireland or in Spain, in the U.S. or in Belgium, everywhere governments have taken great financial risks to prevent the collapse of their financial systems. In some cases – such as Ireland and Spain – the rescue operations had impaired the state budget in such a way that, without help from abroad, not only the banks would have faced bankruptcy but also the states themselves.

For numerous governments, the internationalization of financial markets has led to a peculiar as well as precarious situation: While countries possess only indirect influence on the international negotiations of financial regulation, they are individually liable in the event of a crisis. Their sovereignty is thus asymmetric: So far, the governments of sovereign states were lacking the instruments to reduce the risks that come along with their bank's business; still, they were held accountable. The resulting situation has become both politically unsatisfying and threatening the legitimacy of governments. Some G20 States have responded with the unilaterally implemented measures sketched above.

In principle, individual states would indeed have had the ability to tighten their financial market regulation well before the recent crises in the USA and in Europe. Thereby, they would have lowered the risks for their public finance. However, before the outbreak of the crises it was politically difficult to find support for a prudent policy. Banks successfully referred to the competitive environment in which they have to operate and pointed to the liberal banking supervision in other countries. So prior to the crises, we saw a leveling of the supervision on the lowest common level, which however – as we know today – was highly inadequate.

A second reason for the growing interest in the re-nationalization of financial politics is the experience from the bankruptcy of Iceland's banking system. The three major Icelandic banks were initially growing rapidly abroad, implementing daring business models. Equally quick was their demise, and all three banks slipped into bankruptcy just as quickly. The assumption that a state will guarantee for the liabilities its insolvent banks have in other countries was plausible until Iceland failed to honor the obligations of its banks. The events in Iceland have weakened this expectation. The faith in guarantees of national governments – a central element of the home country principle in banking supervision – is fundamentally shaken. The bankruptcy of Cypriot banks, although somewhat different in detail, has fuelled further doubts. That is one more reason why the U.S. is shifting towards the host country principle.

### **Why do global approaches fail?**

Yet, the tightening of the rules for financial market regulation is not the only field where the G20 is failing. Despite the mantra-like repetition of memoranda of understanding, the trade ministers of the G20 have not been able to surpass their conflicts of interest and reach a settlement in the Doha Round of the World Trade Organization WTO. What are the reasons for this failure?

Although the G20 managed to prevent a revival of protectionist measures on a broad front in the midst of the crisis, there is a large gap between the announcements of the G20 and quantifiable results in trade policy. There is not one final communiqué lacking a clear statement stressing the importance of the World Trade Organization WTO and the necessity to conclude the Doha Round. Nonetheless, the reality of trade policy looks very different. All the states that are preventing the conclusion of the Doha Round through their veto are members of the G20.

Although little information on the reasons for the deadlock in the Doha Round is publicly available, it is known that the USA, Brazil and China are blocking its conclusion. The emerging economies Brazil and China oppose the U.S.'s demand for the complete elimination of tariffs on industrial goods. Conversely, the U.S. resists the request to comprehensively abandon subsidies to the agricultural sector.

Thus, the Doha Round is not concluded because three important members of the G20 no longer believe in multilateral solutions and rather engage in preferential agreements. For experts in the field of international trade, this is a paradox. There is a broad consensus that a single rule book for international trade would facilitate economic growth and contribute to a worldwide increase of prosperity. This, however, cannot be said for the currently so popular free trade agreements. So why are the countries in the G20 incapable of further developing the common rules for international trade?

One explanation is the lack of a hegemonial power, which is willing to guarantee the compliance with the rules of the game, but at the same time also establishes a system that provides the member countries with sufficient economic benefits. In any event, this is how the postwar economy emerged: The U.S. enforced the system of Bretton Woods and made sure that the participation in this economic regime remains attractive. Of course, the Bretton Woods regime never was a truly global system since the member countries of the Council on Mutual Economic Assistance (COMECON) were not participating. Still, within the bipolar order of the Cold War, the U.S. managed to keep the system at the same time open and stable.

After the collapse of the USSR and the following short-lived “unipolar moment” (Charles Krauthammer) of complete hegemony of the U.S., the multilateral order was being developed until 1995, the founding year of the WTO. Since the turn of the millennium and the parallel emergence of a multipolar order, nearly all attempts to organize cooperation without hegemony (Bob Keohane) have failed. The present multipolar world is characterized by superficial cooperation. Global Governance, whether in policies to prevent further climate change or in economic policy, remains on hold. Even worse: The world is returning to regulation on the level of the nation state and non-cooperation. The American political scientist Ian Bremmer refers to the resulting situation as “G-Zero”, an era in which groups as the G20 will no longer play a vital role.

### **The negative perception of the international division of labor**

Apparently there is no such thing as an identity of interests of individual states as assumed by the advocates of global regulation and global governance. In other words: The



gap between the preferences of individual states is increasing rather than narrowing. Governments must, however, respect the preferences of their societies in the formulation of policies if they do not wish to lose legitimacy. Then again, the different preferences of societies are the immediate result of a severely diverging perception of the international division of labor. Even in the G20 the individual societies have very different perceptions of the effects of globalization and its economic effects.

In Europe and the U.S., many people are increasingly critical of the international division of labor, if not outright hostile to globalization. According to a number of surveys, only about one fifth to one third of the respondents in OECD-countries sees greater opportunities than risks in globalization. Even in Germany, numerous politicians and citizens have been expressing a critical perception of globalization, although Germany strongly benefits from open markets and the resulting intensification of international trade.

### **Without a political anchoring in the member states, the G20 has no future**

The critical perception of globalization and the outlined asymmetric sovereignty result in a standstill in the G20. Instead of a further development of the multilateral order, at best the status quo will be preserved. This is why we can expect nothing substantial, at least in terms of economic policy and financial regulation, from the summit of the G20 in St. Petersburg on September 5 and 6. The structural impediments to successful financial regulation and trade policies on a supranational level cannot be overcome by the heads of government and state of the G20. At least, there is hope in those fields, few as they may be, were the countries of the G20 have identical interests. This applies primarily to measures to close down tax loopholes. In 2008, ambitious expectations of a comprehensive reorganization of international trade relations through the G20 were raised. Unfortunately, the G20 cannot and will not deliver in crisis prevention. Today, much more modest goals will have to be set. The key impediment for a successful further development of global rules in trade and finance can be found in the G20 societies themselves. The critical perception of globalization needs to be addressed by policy makers at the national level. The widespread reservations on the international division of labor in the OECD countries need to be addressed. If societies continue to show diverging preferences, the development of comprehensive global economic governance in the G20 will be all but impossible.