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What's missing on the London agenda of the G20

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On 2 April, the leaders of the G20 will meet in London to discuss reforms of the international financial architecture and to agree on co-ordinated measures to deal with the global economic crisis. EU countries have already made suggestions concerning the future stabilisation of financial markets. However, a number of important questions appear to have been left off the agenda so far. For instance, it is not clear what kind of sanctions could and should be imposed on countries unwilling to cooperate in such stabilisation measures. In addition, neither the problems deriving from global imbalances nor potential ways of solving them are being discussed at all, which appears surprising considering current developments. It appears that, rhetoric notwithstanding, governments are only aiming at a small scale modification of the financial architecture.

The standstill in American politics that overshadowed the Washington summit in November has been overcome since the Obama administration took office. The upcoming summit in London is an essential step in the further development of immediate crisis management as well as future reform attempts. The meeting might be remembered as a milestone on the path to economic recovery, with its participants paving the way for a new international financial architecture. But it could also turn out as a disaster like the 1933 world economic conference in London, which marked a historic low in international economic diplomacy and did a great deal to speed up the decline of world trade and financial cooperation in the 1930s.

Whilst the historic importance of the London summit is clear, the positions of important participants are remarkably fuzzy. There is a general consensus about the necessity of reform, but not much discernible direction. One reason for this is probably the incomplete and one-sided way in which the current crisis has been analysed to date. The failures of government financial policy as well as the role of capital exporters and importers are either completely ignored or only mentioned in passing by many official analyses. Clearly, many in the financial industry acted carelessly and engaged in excessive risk-taking. But in most cases, they did so within the law. Some, such as Bernard Madoff, broke the rules to the extent that their behaviour

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was seriously criminal – and were dealt with accordingly. Most transactions, however, were perfectly legal. Government watchdogs and central banks monitored financial markets. Financial institutions under direct state control, such as the state banks in Germany or semi-governmental institutions like Freddie Mac and Fannie Mae in the United States implemented some of the riskiest business models. The carelessness in dealing with financial markets was not limited to private actors but had gripped state regulators in almost all OECD countries. The crisis has many culprits; hence concentrating reform attempts on only a handful of actors and regulatory questions, as implied by the European proposals, is not a convincing way of resolving it.

The strategy of the European G20 members

On 22 February, the leaders of the European G20 member states met in Berlin to conceive a common strategy that would contain both a short-term approach to tackling the immediate crisis and a long-term plan for restructuring the international financial system. The larger part of the European proposals is concerned with the improvement and renewal of international financial market regulation. The EU leaders are intending to eliminate the pro-cyclical effects of banking regulation, primarily to reduce the impact of financial crises on the real economy. The most important instrument in this context is the encouragement of higher capital ratios in commercial banks.

Considering the institutions of global governance, the EU leaders are proposing to double the financial resources of the IMF and to strengthen the institutions of international financial supervision. The IMF and the Financial Stability Forum (FSF) are called upon to develop an early warning system for financial crises. In addition, there is pressure to implement far-reaching regulation of hedge funds, tax havens and other "uncooperative jurisdictions" as well as a more sustainable salary structure in financial institutions.

It is worth asking to what extent these proposals are realistic and desirable to the end of managing the current and preventing future crises. Higher capital requirements for banks seem like a sensible option for future reference, but they will not contribute to crisis management in the short term. Indeed, such measures, if implemented now, could have pro-cyclical effects and hence exacerbate the negative effects on the real economy. Further proposals in this direction seem equally unlikely to combat the immediate effects of the crisis.

Capping executive salaries?

If the financial crisis is seen as a failure of financial markets and financial supervision, it seems unlikely that some years from now, new crises will be prevented by piecemeal measures. Asset bubbles will probably not occur over the next few years because actors on financial markets are probable to act more carefully and diligently as a result of the experience of recent months. Hence the proposed caps on executive salaries currently debated in Europe and the US smack of populism rather than effective crisis management or prevention.

Such restrictions are relatively easy to implement in those banks currently receiving state aid. But when they are reprivatised, which will happen eventually, immediate caps on salaries will be much harder to uphold. It is unrealistic for such rules to be permanently implemented for only a small group of employees; hence, governments would have to introduce general upper limits on salaries. In effect, this would include professional footballers as well as company CEOs. One would be hard pressed to attribute any responsibility for the financial crisis to Michael Ballack or Dieter Zetsche, which exposes the absurdity of these suggestions.

The situation appears even more complicated if one considers that particularly in investment banks, which had a disproportionate share in causing the crisis, employees frequently own company shares and are thus benefiting from profits. At Goldman Sachs, for example, 48 % of shares are indirectly held by the bank's partners, and 22 % by other employees. Dividends paid to shareholders, including partners and employees, are company profits, not salary payments. There is no question that there can be no state-imposed upper limit on company profits in a market economy. If the intention is to impose caps on bankers' salaries, it is to be expected that those affected will come up with innovative ways of getting around these limits.

Furthermore, it is worth asking which parts of those salary payments directly contributed to the creation of bubbles in financial markets. In this context, the effects of Anglo-American accounting principles are worth noting. Bonus payments make up a considerable proportion of the salary of investment bankers and other high-earning professionals. In order to calculate these, one needs to know the value of assets of a financial firm and the profits made, not in the long-term, but at the end of an accounting period. For this, it is necessary to use so-called mark-to-market valuation, not at historical costs, which was to accounting method used in Germany until recently. In order to prevent market participants from short-term thinking to improve their bonus payments, it is appears advisable to use accounting methods that emphasise sustainability, not short-term gains. One option is to return to historical cost accounting, as proposed by the German financial economist Karlheinz Küting, among others.

However, failing this, there is scope for politicians to react to salary levels that are considered unfair or inappropriate. The instrument for achieving this is through taxation. Particularly in the USA, fiscal policy has been overly kind to high-income earners and disadvantaged those with low and middle incomes. Between 2000 and 2005, almost all Americans in employment (96.6 %) faced stagnating or falling income levels in real terms. Only 3.4 % of employees in the US were able to increase their real income. High-earning Wall Street employees were part of this small group benefiting from the tax cuts of the Bush administration.

In the United Kingdom, the low tax levels applied to the highest earning professionals are even more problematic. In the City, large parts of bankers' salaries are taxed as capital gains. Even after a tax reform by the Brown government, the capital gains tax rate, at 18 %, is lower even than the minimum rate of 20 % applied to very low income workers such as cleaners or kitchen aides. Before the reform, capital gains tax was only 10 %. Harmonising tax law in OECD countries, including the abolishment of special exemptions for capital gains, would therefore be a much more sensible measure than the populist announcement of upper limits for executive salaries.

Similar reservations apply to the recent proposals of a transaction tax for stock markets. Could such a tax have prevented the current crisis or at least reduced its effects? This is clearly not the case. In the UK, a tax of this kind (the so-called „stamp duty") has been levied on particular types of shares and certain bonds at a rate of 0.5 % since the 17^{th} century, but this has not prevented the extreme exaggerations on British financial markets.

Derivative products, i.e. financial products the value of which is derived from a certain base value, have had a decisive influence on the severity of the present crisis. However, derivatives used to be traded outside financial centres, i.e. privately over the counter. A transaction tax applying to the stock market would not affect the volume of transactions in this case. Of course, it is conceivable to transfer the derivatives trade to the stock market by law and then levy a transaction tax of the above kind. Even a relatively small tax rate of 0.5 % would then reduce the derivatives trade considerably. Of course, the critical issue here is to prevent the transfer of business transactions to financial centres that do not levy this tax. Like in other aspects of re-regulation, the avoidance of regulatory arbitrage is yet an unresolved issue.

Offshore Financial Centres, Tax Havens – and Central Banks

This is maybe the most important question in the entire discussion about reform: Which mechanisms could protect well-regulated financial centres from competition by those which are badly or not at all regulated? Within the G20, there appears to be a general consensus that no financial centre and no bank should be left unsupervised. That is plausible: Only universal supervision could ensure that no race to the bottom takes place between financial centres and that the instruments of each national financial supervision regime work properly without being undermined. Still, the idea of a far-reaching, powerful world financial supervision institution appears slightly delusional. No large economy, but particularly not the US, would agree to such a serious infringement of their national sovereignty. Even in Europe the political will to create a unified regulatory regime is lacking. Why should an idea that is failing to obtain the support of a majority in Europe suddenly be successful on a global level?

Apart from that, tax havens and offshore financial centres did not play a decisive role in causing the crisis, much like the frequently criticised hedge funds. The crisis originated in the centre of the world economy, with most important perpetrators subject to some form of financial supervision, however effective. Central banks have to take a substantial part of the blame. In particular, the US Federal Reserve and its monetary policy contributed a great deal to the emergence of the crisis, as Alan Greenspan's asymmetrical policy only considered speculative bubbles once they had burst. Other central banks, such as in Iceland, the Baltic states or Ireland, were also guilty of simply ignoring systemic risks in their economies. To its credit, the ECB acted more prudently in this area, continuously pointing out the dangers that might arise from inflated asset prices.

Bearing this in mind, it is surprising that the role of central banks is not a major point on the G20 agenda. The paradigm that independent central banks are the best way to achieve lasting monetary and financial stability has lost some of its force in the light of recent events. Clearly, it would be a bad idea to discuss reforming the mandate of central banks in the midst of a crisis when its management and resolution is largely dependent on their work. But the professed aim of the G20 is a revamp of the financial system after the crisis. In the medium term, it is therefore worth asking what monetary policy could contribute to preventing future financial crises. Central banks would have to find ways of developing a concept of financial stability which is concerned with more than just inflation control. In particular, they would have to monitor prices of the most important assets, i.e. shares and real estate, and tighten monetary policy in the face of observed irrational exuberance.

The concepts for a universal system of global financial supervision are not yet very specific, particularly with respect to enforcement of the G20 rules against states that do not cooperate with OECD-economies. Sanctions, such as the cancellation of double taxation agreements, are a possible option when dealing with smaller jurisdictions. But this does not solve the problem since financial centres with low levels of regulation, such as Ireland or the UK, played a much more important role in the early stages of the crisis than unregulated offshore centres. London as well as Dublin more or less openly used their slack banking regulations for advertising purposes. In the years preceding the crisis, many banks shifted their activities from New York City to London, since the US administration had tightened their regulations following the Enron scandal by implementing the Sarbanes-Oxley Act. It did not prevent the present crisis, but it caused an exodus of financial transactions from Wall Street to London. Similarly, Dublin attracted participants in the financial markets, not least from Germany, by advertising its "generous" supervision institutions.

This is a structural problem which could of course be solved if there were universal global standards for the supervision of banking activities. It would be essential not only to use identical rules, but also to apply the same level of enforcement. That is completely implausible considering that the financial markets in Dublin, Dubai, London and Mumbai are as distinctive as the cities themselves.

The claim that it is possible to implement universal standards of regulation on a global scale betrays an apolitical perspective because it does not take into account the interests of actors involved in the decision-making process. In times when the going is good, which will eventually come back, carelessness and risk-taking behaviour are a promising path to considerable economic advantage. That is what happened in Reykjavik, Dublin and London until the bubble burst.

Considering this, the concept of universal global supervision favoured by the G20 could only work if it were combined with a globally enforceable regime of sanctions. Since this is not the case, the sustainability of the proposed supervision regime is in question. Before long, the incentive to break the rules will grow again, particularly if even small breaches would yield massive gains. If a worldwide system of banking supervision were to be developed, the incentive to find ways around it would be all the greater – and all the more greatly profitable.

Global imbalances: Too toxic to handle?

Since it appears unrealistic to create universal standards of regulation, the relationship of national financial markets with each other will be a central aspect of a new world financial order designed to avoid bubbles and crashes. International capital flows played a decisive role in the present crisis. Badly affected countries such as the USA, Iceland, Ireland, Latvia, Hungary and Spain recorded high levels of capital inflows during the phase immediately preceding the crisis. This phenomenon has frequently been observed in the history of financial crises; about three quarters of financial crises that occurred in the past few decades were characterised by high capital inflows during the years preceding them. To list only the most important, this

Table 1:
Current account deficits in pre-crisis years in selected countries

Country	*Current account deficit as a percentage of GDP/year*	*Current account deficit as a percentage of GDP/year*
Argentina	−6,2 (1980)	−6,0 (1981)
Brazil	−5,5 (1980)	−4,5 (1981)
Mexico	−5,4 (1980)	−6,5 (1981)
Australia	−6,1 (1989)	−5,2 (1990)
Mexico	−5,8 (1993)	−7,0 (1994)
South Korea	−1,7 (1995)	−4,2 (1996)
Thailand	−8,1 (1995)	−8,1 (1996)
Brazil	−4,0 (1998)	−4,3 (1999)
Argentina	−4,8 (1998)	−4,2 (1999)
USA	−5,9 (2005)	−6,0 (2006)
Ireland	−5,4 (2007)	−6,2 (2008)
Iceland	−25,0 (2006)	−15,5 (2007)
Greece	−11,1 (2006)	−14,1 (2007)
Spain	−8,9 (2006)	−10,1 (2007)
Estonia	−14,7 (2006)	−17,3 (2007)
Hungary	−7,5 (2006)	−6,4 (2007)
Latvia	−22,7 (2006)	−23,0 (2007)

Source: World Bank (World Development Indicators Online), OECD (Economic Outlook Database) applied to the Latin American debt crisis in the early 1980s, the Australian crisis in 1991, the Mexican crisis in 1994/95, the Asian crisis in 1997/98 as well as to the crisis in Russia and Brazil in 1998.

The data in table 1 show very clearly that many financial crises were preceded by high capital inflows from abroad. Evidently, such inflows did not automatically cause financial crises, but the empirical results point to the increased vulnerability of economies due to sustained capital imports. Before the present crisis, many of today's crisis countries were running large current account deficits. On the other hand, it is worth noting that countries with smaller deficits or even surpluses were much less vulnerable to financial crises, even though this did not protect them from the effects transmitted to the real economy.

However, it is obviously impossible for all countries in the world to run current account surpluses at the same time. According to accounting rules one economy's surplus is another's deficit. But this does not change the fact that it might be possible to draw some conclusions about the risks posed by high and sustained capital inflows based on the above findings. Why is this not an issue on the G20 agenda? Is it too controversial and complex for the countries involved?

This seems likely, since both surplus and deficit countries have an interest in ignoring this topic. Surplus countries have a preference for production and export of goods and services, with motives differing from one country to the next. In Germany, the title of "leading world exporter" is not just seen as demonstrating the competitiveness of businesses located there, which is correct, but also as a cunning economic strategy, which is less convincing. China, on the other hand, is aiming for fast growth and believes that increasing exports is the best strategy to do so. Similar to Germany, China does not only produce goods but also offers capital to pay for them to its customers, particularly the US. Hence why the Bank for International Settlements termed the capital flows from China "vendor finance" back in 2004. The deficit countries, too, have no interest in a detailed discussion of their dependency on capital inflows, particularly in the midst of a crisis.

Still, the complete absence of this issue from the G20 agenda is not prudent. It should be remembered that analogous to the deficits preceding it, there is a regular tendency to current account surpluses after a crisis. The countries affected in the 1990s, such as Brazil and South Korea, are now exporters of capital and hence supporting unsustainable constellations in other countries. Thus, one crisis contains the seeds for the next, since yesterday's deficit countries will be tomorrow's surplus countries: Economies hit by a financial crisis tend to aim for surpluses afterwards. The only way to solve this problem is to recognise surpluses and deficits as two sides of the same coin. High, sustained surpluses have to be sanctioned in the same way as high deficits. As the market does not punish the running of surpluses, this is a task for the international community of states and should be dealt with by the G20.

At the same time, it should be discussed how the considerable fluctuations in capital flows to developing and emerging economies could be prevented. In 2007, around 930 billion US dollars of capital inflows reached emerging markets. This year, this sum will be reduced to 165 billion dollars, according to estimates of the Washington Institute of International Finance. These fluctuations are causing considerable adjustment problems in those countries, who are complaining that in addition to the real effects of the crisis caused by OECD countries they are now also cut off from fresh capital.

How to reform the IMF?

In theory, the institution best cut out to deal with global imbalances would be the International Monetary Fund, but unfortunately it has not yet been sufficiently reformed to meet the growing expectations it faces to the end of becoming an internationally accepted and legitimate institution.

The European plan to increase IMF resources and strengthen international financial institutions in general appears sensible at first sight. The fund currently has only 140 billion US dollars in freely available resources; in addition to that around 50 billion in loans that can be mobilised quickly plus an extra loan of 100 billion offered by Japan outside the quota system. These are fairly modest sums compared to the foreign currency reserves that have been accumulated worldwide. China alone holds 2000 billion dollars and even Brazil, which in 2002 obtained the largest ever single loan issued by the IMF, 30 billion dollars in volume, today has foreign reserves of 200 billion dollars.

However, the EU proposal does not go far enough. The original role of the IMF was to provide capital to countries with short-term liquidity problems. In theory, it is not meant to implement far-reaching structural adjustment policies in the context of a crisis. Today, the IMF and the transatlantic powers shaping its policies should reconsider this central function. The Fund still has not presented any convincing programme for liquidity provision. States have accumulated a total of 7,000 billion US dollars in foreign currency reserves to prepare for times of crisis. Increasing IMF resources to 500 billion dollars only makes sense if this is combined with a new programme for managing financial crises that is acceptable to all potential customers.

This includes political reform to the end of redistributing the positions of power within the fund. Unsurprisingly, this problem is largely ignored by European countries, since Europe has about a third of IMF votes and any attempt at reform would clearly reduce this disproportionate share. The European insistence on keeping things as they are is no longer convincing as new world economic powers have been on the rise for some time. Wen Jiabao, Prime Minister of China, has demanded that a redistribution of voting rights and decision-making powers to developing and emerging economies should be agreed *before* any potential increase in IMF finances. The order preferred by the Europeans – increasing resources before evaluating the rights of developing countries – appears like an attempt to push the European agenda in order to sweep the demands of developing countries under the carpet again.

European governments would do well to notice that even today, structures are emerging outside the IMF that might threaten its future. Rather ironically, it is the US who have already started to implement new forms of international financial cooperation. In October 2008, the US Federal Reserve concluded swap agreements – loans against domestic currency – with the central banks of Mexico, Brazil, South Korea and Singapore amounting to 30 billion US dollars in each case. The same country that blocked reforms of IMF loan conditions for years has thus created new financial instruments – without the Europeans.

The limitations of early warning systems

Nevertheless, the proposals to strengthen the IMF seem well-founded overall, notwithstanding the need for some modifications. This does not apply to the plan to create an early warning system for financial crises, which appears more like an attempt to cover up the failure of the existing financial supervision institutions in Europe and North America. One should bear in mind that institutions which are meant to notice warning signs and act accordingly are already in existence. However, with respect to the current crisis, they have failed abysmally: The American financial supervision authority, for example, had been receiving warnings about the Madoff Ponzi scheme for several years when the bubble burst without taking any of them seriously. The risks of packaging loans into tradable shares were lost both on them and the IMF.

A similar criticism applies to the proposal to close tax havens and regulate hedge funds. Regardless of whether this is potentially desirable or necessary, neither tax havens nor hedge funds played a particularly important role in bringing about the crisis, hence changes in this area are unlikely to help combat its effects in the short term. Dealing with immediate problems resulting directly from the crisis should currently take precedence over measures that are populist and not immediately conducive to resolving it.

In this context, the European vow to complete the Doha Round and to fight protectionist tendencies is laudable, since a further reduction in world trade is clearly one of the greatest dangers for the world economy at the moment. However, coordinated measures to stimulate demand on the part of European countries would supplement this move and might set a precedent for the Obama administration whose take on the Doha round appears more sceptical.

A broader agenda for the next summits

Although it is currently necessary for governments to play the role of saviour general, it should be remembered that it was not just financial markets, but also central banks and state financial supervisory authorities that contributed to the crisis. Lax regulation and insufficient or wrong-headed state supervision and intervention played a much larger part in bringing about the crisis than the hedge funds and tax havens that state-sanctioned crisis managers are so quick to condemn now.

When potential reforms are discussed on the G20 level, it is important to focus on questions that have not yet made it onto the agenda. This includes an evaluation of international capital flows and potential measures for the prevention of sustained deficits and surpluses on the current account. Just as important is a re-definition of the role of central banks which in future must not be content with simply countering inflationary tendencies. Looking at the institutions of international financial policy, particularly the IMF, it is necessary to discuss far more radical steps than an increase of IMF credit volume. These issues belong on the agenda of the G20 meetings that will inevitably follow London.

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