Assembling a New International Financial Architecture: The G7's 2001 Role and Response

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Introduction

Since its 1975 inception, the Group of Seven (G7) major industrial democracies, operating at both the leaders and ministerial levels, has played a central role in shaping the international financial system, and using it to contain systemic crises and foster sustained global growth (Bayne 2000a, Bayne 2000b, Putnam and Bayne 1987, Funabashi 1987). As the age of intensified globalization took hold during the latter half of the 1990's, bringing with it a series of financial crises that culminated in the great Asian-turned-global crisis of 1997-9, the G7 played an ever more central and ultimately successful role in crisis response, global macroeconomic management, and financial system reconstruction (Hodges, Kirton and Daniels 1999, Kaiser, Kirton and Daniels 2000, Kirton, Daniels and Freytag 2001). It did so largely by working through the International Monetary Fund (IMF) and newer bodies such as the International Monetary and Financial Committee (IMFC) and the G20, and operating as a concert within which a process of mutual adjustment and a sense of collective responsibility prevailed (Kirton 2000, 2001a). As the new century dawned, the G7 appeared to have placed a new, effectively functioning edifice firmly in place (Kirton 2001b, Bayne 2001, Kirton and von Furstenberg 2001).

The year 2001, however, brought two severe challenges to this new edifice, and the comfortable conclusion that the G7 had adapted well to the intensely interconnected, fully global financial system of the new age. The first, external, challenge arose from a series of assaults from the markets. Financial crises erupted in Argentina and Turkey, with their effects spreading to other countries such as Indonesia and raising the prospect of rampant and devastating global contagion once again. Driven by a sharp downturn in the internet-based "New Economy," by rising oil prices and by increasing inflation, the United States, then Japan and Europe entered a period of sharply slower growth, threatening a serious global slowdown that could imperil the task of crisis response, global growth management and fulfilling broader responsibilities such as development and debt relief of the poorest. And the international financial system seemed to need a new generation of reforms, not only to strengthen private sector accountability and mobilize more money for crisis response, but also to narrow the IMF's very focus and mission, reinvent it as a crisis prevention mechanism, and improve its relationship with reformed multilateral development banks. Together these events raised the spectre of a return to an alleged tendency, identified in the mid 1990's, for the G7 to retreat to impotent inactivity in the face of globalized markets they felt they could not longer control (Bergsten and Henning 1996). They even suggested, more broadly, that the world's major governments had been rendered relatively powerless by a world of rampant globalization and the prevailing neo-liberal ideology and "constitutional" confines it brought, and that recent efforts to counter with a "third way" of a socially sensitive approach to global governance was for naught (Gill 1993, Cerny 1995, Kirton 2001).

The second, internal, challenge was a sharp rightward shift within most major G7 governments, as new political leaders took office. The shift began in the United States with the narrow election of President George W. Bush. His new Treasury Secretary Paul O'Neill began by questioning the very value of the G7 Finance Ministers forum, of G7 governments' provision of second lines of defence to combat financial crises, of much of what the IMF and multilateral development banks (MDB's) had recently done (including support for a democratizing Russia), and the G7's success in fighting money laundering through the Financial Action Task Force (FATF). The spring brought the advent in Japan of a new Prime Minister Junichiro Koizumi, whose bold promise to end an era of massive fiscal deficits and financial relief for ailing banks appeared to repudiate the Keynesian orthodoxy, backed by carefully calculated political patronage that had long prevailed. Elsewhere the election of the government of Silvio Berlusconi in Italy in May 2001, following that of Vladimir Putin as President in Russia at the outset of 2000, seemed to confirm the sharp rightward shift. Although the re-election of the centrist governments of Tony Blair's Labour Party in Britain in June 2001, following that of Jean Chretien's Liberals in Canada the previous year promised a loyal opposition lodged in the G7's two smallest countries, the new right wing, U.S.-led new right coalition seemed to have the weight to dominate the much reduced "third way" caucus of old. Even if it did not, the new division and resulting paralysis within the G7 could more easily allow the market driven forces much loved by the Bush administration more easily to prevail.

In the face of these severe tests from a fragile global economy and new U.S.-led market friendly leadership, however, the G7 proved able to offer effective concerted financial governance during the first half of 2001. It ensured adequate growth in the global economy through a continuation of its longstanding emphasis on structural reform, and by returning, under U.S. leadership, to the "locomotive" theory that flourished in the interventionist 1970's and that led to some of the G7's greatest successes (Putnam and Bayne 1987), before being discarded by the new neo-liberal non-interventionist "Ronald-Thatcherism" that the 1980's brought. With a United States easily setting aside its ideological convictions and complaints, the G7 quickly mobilized through the IMF the large sums required to stabilize Turkey and the Argentina, and with them Europe, the North Atlantic Treaty Organization (NATO), the democratic Americas, and the emerging markets as a whole. Within the international Financial Institutions (IFI's), the U.S. did provide an added impetus to the private sector participation and "back-to-the basics" focus that others had long been promoting. But the Bush administration continued its enthusiastic, if ineffective support for a Contingent Credit Line (CCL) facility that the Clinton administration had invented, took up the prevailing consensus on debt relief for the poorest, and rapidly accepted much of the French-led consensus on money laundering and financial abuse. Thus adequately effective G7 action, grounded in a U.S. that readily adjusted to the prevailing G7 consensus, proved to be the dominant trend.

This rapid restoration of the G7's effective concert spirit and adequate action in the face of severe market challenges and of a sharp initial policy assault from a new U.S. administration is readily explained by the core features of the concert equality model of G7/G8 governance (Kirton 1999, 1993, 1989). Despite the rise in the value of the U.S. dollar to its highest trade-weighted level in 15 years, the much stronger G7-leading plunge in U.S. Gross Domestic Product (GDP) led even initially inward-looking U.S. leaders to drop the American arrogance at the 1997 Denver Summit, to recognize they needed stimulative help from their G7 partners, and to revive the Carter-like collective locomotive approach in response. The relatively strong currencies and growth of the G8's smallest members, Britain, Canada and Russia, assisted this U.S. awakening, in an era where the integrated production in the North American Free Trade Agreement (NAFTA) area, tightly wired financial markets that joined London to New York, and an emerging energy "crisis" appropriately focused the U.S. administration's mind. The intensifying interdependence and intervulnerability bred by globalization was recognized with equal ease and rapidity both by a slowing Germany, once tempted to assume that its Euro-fortress growing more rapidly than America could survive without help from or for the United States. Contagious intervulnerability combined with the common purpose of support for democratic and market principles to induce the U.S. to put aside its doubts about large, bureaucratic international organizations, and have the IMF give financial support to a democratic, secular, NATO ally and western-oriented Turkey, and a democratic Argentina vital for the realization of a western hemisphere in which free trade and its freedoms flourished. Finally the new political leaders in the U.S. (as in Italy) were largely familiar with and committed to the G7/G8 system and its strengthening, even as in the U.S. the narrowest of political victories for the Presidency and margin of dominance in a divided Congress placed severe constraints on any ideologically-driven enthusiasms. It is also relevant that the individuals in the two remaining "third way" G7/G8 governments, at both the leader and finance minister level, were both recently re-elected with massive majorities, came from parliamentary systems where ministers have a popular mandate, and were the longest serving G7/G8 veterans in their positions, having come to Summits and G7 finance ministers meetings since 1994 (host Berlusconi's first) in the case of Canada. Indeed, what is remarkable in the light of the past great G7/G8 political transitions to the "Ronald-Thatcher" conservative era of the 1980's, and the Clinton-Chretien-Blair-Schroeder-Olive Tree "third way" of the 1990's, is how easily the G7/G8 institution socialized the Bush-led conservatives of the twenty-first century into a continuing, consensus approach.

To explore the cadence and dynamics of this socialization process, the impact of relative capability, crisis-activated intervulnerability, democratic commonality and popular political control in producing it, and the adequacy of its policy result in the face of market forces, this paper examines the G7's and IMF's response to the challenges of global growth, financial crisis, international financial architecture and related issues during the first half of 2001. It explores in turn the work of the G7 at its stand-alone February meeting in Palermo, the activity of the G7 and IMFC at their April meetings in Washington, the core issues concerning reform of the IMF, the behaviour of the G7 at its pre-Summit meeting in Rome on July 7, and prospects for the finance and economic agenda of the Genoa G7 summit itself.

The G7 Finance Ministers at Palermo, February 17, 2001

The Palermo G7 Finance ministers meeting was the first of the 2001 season, the first for the Italian 2001 G7/G8 chair, and the first for the new United States administration and its Treasury Secretary Paul O'Neill. It suffered from several political disadvantages. Italy was led by the centre-left coalition government of Guiliano D'Amato that was likely to be, and was, voted out of office in the general elections of May 13, 2001. The Bush administration was not fully installed in Washington, given the delay in the Florida recount. As a result the U.S. Treasury team was still busy making and securing Senate approval for its senior appointments. Indeed, some needed special approval from Congress, prior to their formal approval, to even make the trans-Atlantic trip. And even as they were flying to Europe, they were preoccupied by the prospect of a sharply slowing US economy, whose decline had been drastically signaled by the stunning mid-meeting interest rate cut by Federal Reserve Chairman Alan Greenspan at the very beginning of January.

Even so, the prospective market challenge from a rapidly slowing U.S. economy had not emerged with full force by the time of Palermo. Despite the Greenspan surprise and the advent of slow U.S. growth in the fourth quarter of 2000, the U.S. stock markets and their "new economy" component were still at elevated levels, several economic indicators were promising, and there was faith that Greenspan's action alone would restore any confidence that might be needed. Moreover in Europe, and even in some quarters in neighbouring Canada, there was confidence that even in an age of "globalization," indigenous factors, such as solid growth and tax cuts, could allow them and thus the global economy to escape any dismal US economic fate.

The political assault from the new U.S. administration was much more acute. Just before leaving for Palermo, newly appointed U.S. Treasury Secretary Paul O'Neill, perhaps reflecting his background in the private sector as CEO of Alcoa, publicly expressed skepticism about the very value of the G7 intergovernmental forum, implying the forum would have to prove itself to the U.S. if he were to return. He indicated he was going to Palermo to listen, suggesting U.S. leadership or even an open discussion of the new administration's priorities might be lacking. With he and his associates harsh critics of the G7-led IMF bailout of Russia and of financial support to beleaguered emerging economic during the 1997-9 financial crisis, and great believers in private sector capital, free market forces and low taxes in the U.S. and abroad, there were little prospects for an instant meeting of the minds. There was also the possibility of a failure of the G7 forum.

As it turned out, the G7 at Palermo passed its test from Paul O'Neill. Equally importantly, the U.S. Treasury Secretary passed his test implicitly given by his G7 colleagues. He left issuing reassuring words about the value of the forum. The ministers had a good exchange on a wide range of issues, including developments in the world economy, exchange rates, emerging market economies, Russia, debt relief for the Highly Indebted Poor Countries (HIPC), development beyond debt relief, strengthening the international financial architecture, reform of the multilateral development banks, and financial abuse and the FATF. The agenda reflected in a balanced fashion new U.S. priorities such as MDB reform, those of common concern such as development beyond HIPC, and those where other G7 partners were in the lead, such as financial abuse.

Discussion of these issues at the meeting avoided any sharp divisions between the new US team and its partners. Some of the new U.S. initiatives were approved and recommended to the IMF for further work And externally, the concluding Communique and the individual ministers sounded a reassuring note of harmonious optimism about the state of and prospects for the global economy (G7 2001a). Given its political prospects Palermo as a "get-acquainted" meeting was a strong success. Given global economic conditions and market uncertainties, as an exercise in forward-looking, preventative economic management, it did much less well.

The G7 and IMFC at Washington, April 2001.

Ten weeks later in Washington, the G7 and the larger IMFC faced much the same agenda, but with a new emphasis and with a far more formidable set of market circumstances to face. The challenge from American political change was considerably reduced. Whereas American passivity at Palermo could be attributed to the fact that the meeting was held at a moment too early for the new US team to impose their agenda and approach, in April in Washington, the US was the host of the G7 meeting. Yet O'Neill was still largely silent, still listening, and as it turned out, learning. Apart from his undersecretary for international Affairs, John Taylor, who had just been confirmed, very few of his officials were fully in place. America's "listening and learning" approach continued through the discussions and decisions on the five urgent matters that dominated the agenda.

Global Growth Prospects

The first was the now deep concern about global growth prospects. Here the mood had changed dramatically since January. There was now a real, well recognized and ever deepening slowdown in the US. Japan remained moribund. And now in a previously resilient Euroland and Europe, growth was falling off. Many speakers at both the G7 and IMFC meetings bravely called attention such remaining bright spots as low unemployment, moderate inflation, sound fiscal positions and hence the maneouvering room that surplus governments with a tax-cutting or spending dispositions had. This brave burst of confidence was the tone reflected in the communiqué (G7 2001b). But in the meetings themselves, there was clear anxiety among the ministers and central bank governors about the prospects for 2001.

Turkey, Argentina and the Emerging Market Economies

A second anxiety related to the newly precarious situation of, and prospects for, the emerging market economies. This was of concern particularly for the G7 but also for the IMFC. In April both Turkey and Argentina dropped onto the danger list, leading the emerging market bond market and sovereign debt market to plunge. This threat of another contagion was uppermost in the minds of G7 and IMFC ministers as they sought to stabilize the situation in the two critical countries. Once again, as it had in the recent past in Indonesia, Korea, and Brazil, the IMF rode to the rescue. But in this twenty first century installment it did so in a far more flexible and country-specific manner. The G7 ministers applauded the IMF for its new-found desire to tailor its rescue programs to individual country cases and specific circumstances. Their feeling was that this was the right way forward, especially as the two current crisis cases were quite different. Argentina was a currency-based adjustment. Turkey had a crawling peg that the IMF was encouraging Turkey to float. Their anchor was a monetary based quasi-inflation target.

This G7 consensus reflected the ease with which the new Bush administration adjusted to the clear and present danger from abroad. At the time it was slowly developing an international economic policy approach, and one that was more conservative than its predecessors, particularly on the role of the IMF and crisis resolution. In response to individual crises such as Turkey and Argentina, however, it proved to be quite pragmatic. While its instincts were for the IMF to provide a small rather than a large package, its examined each case on its merits. At the IMF Executive Board's discussion of the Turkey package, where US could have vetoed the proposed measures, the U.S. submitted a surprisingly reasonable statement that identified the pros and cons and on balance offered support. The appointment as Undersecretary for International Affairs of John Taylor, a known internationalist and IMF supporter, should mean that this pragmatic approach will continue to prevail.

A second novel element of the IMF response was the emphasis on a large amount of private sector involvement. In a memorable German phrase first used by Helmut Kohl in regard to Russia and now borrowed by IMF Managing Director and former G7 sherpa Horst Kohler, IMF money was to be "help for self help". The emphasis was on "forced haircuts, to send the message that if private investors make a mistake, they will pay and not be bailed out by the public sector funds of the IMF. Horst Kohler was adamant that there would be no public bailouts for bad investment decisions, that the private sector must be responsible for its actions, and that there would be winners and losers alike. Private sector responsibility thus became a key conviction of both the IMF and G7.

This new consensus was consistent with the views of the US and the significant change in the US approach that the Bush administration brought with it. With Bush there was a much more pointed perspective on private sector involvement in the overall U.S. approach. Yet the crusade for affirming this principle within the G8 had long been led by Germany and Canada, and more recently by Horst Kohler as head of the IMF. The US under Clinton, Rubin and Summers had resisted, preferring the flexibility to bail out New York investors should the economic or political need arise (Kirton 2000). While change in the US position and new US support helped give this principle a much sharper emphasis, it was by no means an initiative that the U.S. led.

A third element of the new approach to emerging market rescues was the clear statement that for Argentina and Turkey, this really was the last chance. If either or both failed, no more money would be forthcoming, even as risk premiums rose across the developing countries. Yet the IMF was cautiously optimistic these programs would work, given the massive amount of money leveraged, and the catalytic role of the IMF acting on others. The IMF had given the recipients reform programs a veneer of respectability, to help sell the program to markets and to their own societies. The IMF judged Argentine finance minister Cavallo to have done very well with his debt swap, and Turkish Economy Minister Kemal Dervis to be have put his career on the line as a sign of his commitment to the success of this reform program. The belief that the program must succeed was one that would be injected into the G8 leaders discussions at Genoa.

In this package, the new US administration could claim that no national monies were used in a second line of defence, and that the recipient governments were forced to undertake the harsh but needed domestic reform program before rather than after the IMF money arrived. But the IMF-only approach referred to a channel rather than to the origins of the money, for in the IMF the US and its G7 partners still committed the larges funds and commanded the largest share of votes. And the fulfillment of the conditions was a matter of timing, tactics and optics rather than any fundamental change. The test for real change would only come if Turkey's reformed program failed and President Bush were prepared to do nothing as his NATO ally, partner in Iraq, and secular bastion against Islamic fundamentalism at the crossroads of the Middle East descended into chaos.

Crisis Prevention and the Role and Reform of the IMF

At the G7 and IMFC meetings there was a very clear consensus on the importance of crisis prevention and the integrally-related issue of the role and reform of the IMF. The IMF, always a crisis resolver, was now to reinvent itself as a crisis preventer. The G7 emphasis on crisis prevention spawned a tremendous amount of work for the IMF, as G7 proposals, codified in the communiqué, were pushed into the machinery of the system. The IMF, with the agreement of the G7 and the entire membership, was charged with detecting and preventing financial crises. The key here was surveillance of the global economy, in keeping with the IMF Articles of Agreement mandate to conduct firm surveillance over exchange rates and the global economy." The IMF would thus enter countries to provide objective and clear advice. It would, working with the finance ministry in member countries, develop and publish indicators of risk, such as macro prudential indicators (MPI), as a main instrument of crisis prevention. It would develop data of leading indicators of crisis in a country. It would conduct "stress tests" on national financial systems, asking, for example, "how would an economic downturn affect bank's portfolios and could this be the start of a crisis?" "What is the level of non-performing loans?" "What is the level of short term debt?" "What is the composition of the debt – is there a bias toward a single currency?"

The G7 and IMF also authorized the use of standards and codes. This had been an initiative of Britain and Canada, supported by Japan and Germany, but always one that the US could live with or without. The U.S. now became a convert. The IMF now decided to develop reports on the observance of standards and codes (ROSC), as the most effective way of peer pressure. This would lead to the diffusion of best practices from one country to another, across a wide range of areas, including fiscal, monetary, and banking policy and supervision and money laundering.

A further decision, reflecting a very strong G7 priority led by the Germans and the US, was to proceed with a Financial Sector Review Program. Here the IMF would enter a member country, assess the national financial system, deliver a report to the minister, and give the IMF Executive Board and subject government a report that would be discussed at the IMF Board. The IMF, in a once-in-a-generation move, created a new department to conduct the supporting work.

Also reinforced was the move toward greater transparency. This was perhaps the most striking difference at the IMF over the previous five years. The UK and Canada had strongly pushed the principle of transparency, secured the support of the US and thus produced a sea change. The new emphasis was on as much public reporting as possible, designed to make the IMF the most transparent international organization ever. This represented a complete change in culture and mentality, and one cemented in the attitudes of a new generation of staffers at the IMF.

With the G7's approval, the IMF continued its move to change lending instruments and streamline conditionality (Kirton 2001b). It reduced the number of lending instruments, raised the interest rates for using them and lowered the time they could be used before countries would have to return to the private sector and abide by market principles. In doing so the G7 declared that the IMF was not a development institution.

One issue that aroused considerable controversy at the G7 meeting, but that was not mentioned in the communiqué, was "streamlining conditionality." Germany, France and Japan pushed hard on this issue. The US, along with Canada, Britain and Italy, stood opposed. They argued that lending and conditions should ensure the success of the reform program, and that the IMF would get its lent money back. They pointed to the fact that Article 1 of the IMF Articles of Agreement said it was to lend with safeguards.

The HIPC Initiative

At both the G7 and IMFC meetings, there was broad satisfaction with the HIPC initiative. Indeed, there were discussions of a post-HIPC era that would go beyond reducing the nominal value of the debt. Under the influence of civil society organization, the IMF and World Bank were challenged with the question: "how do we keep the HIPC recipient countries out of debt rather than have them move into a new destructive cycle of borrowing and default". This issue of longer-term debt sustainability would arise, cautiously, at the Genoa G7 gathering. Here the G7 was slated to approve: 1. tracking poverty-related expenditures on the poor in HIPC countries to see where the governments spend their debt relief. 2. the quality of their PRG Strategy. The IMF would encourage the government to talk to their societies, as they had seldom done before, and not support those countries that did not. Now the elite must involve the poor they are trying to help. Britain was the leader in this crusade, having been the most vocal on this issue over the past few years.

A further G7 demand was that recipient countries improve the environment to attract investment and thus reduce poverty. This was the one initiative from Paul O'Neil, who otherwise remained silent. His views may have been infused by those of his new deputy, John Taylor. Taylor who stressed the need for better trade opportunities for the LDCs.

New Governments

A final issue was the need to understand the new economic thinking, priorities and approach of the new governments in the US, Italy and Japan. Here the value of a deliberative as well as a directional and decisional G7 was underscored. The new governments could dramatically change the G7 and IMF. While it was still too early to see the impact, there were early indications of what the new US attitudes and approaches might be. One was a shift away from large financing packages to crisis prevention, and private sector involvement. Another was a new US coolness to prosecuting countries that offered lower taxes in their national “havens.”

Reform of the IMF

The G7 at Washington also addressed the broader issues of IMF reform, as part of its ongoing effort to assemble a new international financial architecture. It did so with some satisfaction that the IMF, thanks in large part to G7 efforts, was a very different institution, in some ways, than it had been even five years ago. Yet there was a broad consensus internationally that, looking ahead, the IMF should focus on three things. These were: 1. promoting macroeconomic and financial stability as a precondition of sustained economic growth; 2. fostering the stability and integrity of the international monetary and financial system as a global public good; and 3. helping members develop a sound financial sector to protect against risk and mobilize finance and take advantage of the opportunities of globalizing financial markets. The IMF would thus move out of structural policy, unless it had a direct bearing on the macroeconomic situation. It would also modernize its financial instruments, so that it would no longer compete with private lenders, but rather shepherd countries toward private instruments. It would thus institute sharp surveillance of how it spent.

As part of the reform package, a reluctant G7 and IMF acknowledged it would have to have what many regarded as an unworkable and counterproductive, but now revamped, CCL. This was for the simple reasons that the US, as much under the Bush successors as under its Clinton inventors, was enamoured of the instrument and to have emerging market countries ask for one. The US saw CCL as a precautionary part of the new crisis prevention emphasis. Under the CCL, if a country was following good policies and wanted access to a line of credit, the IMF would review the request and have 10-15 billion dollars accessible instantly should the need arise. U.S. hegemony thus forced a reluctant G7 and IMF to accept the CCL as a lending instrument. But thanks in large part to the conditions the G7 placed on its use, a hegemonic US under Bush still proved unsuccessful in having a single country, even neighouring Mexico, even in a world awash in financial instability, request a CCL. The US victory remained a purely conceptual one (Kirton 2000, Kirton 2001a).

A further, if much slower IMF move, was to streamline conditionality. The IMF began to offer concepts, with a view to inviting comments, reading papers and discussing them at the Board.

There was a further interest in focusing the IMF on what it did best and having countries take ownership of their reform programs. To cultivate national ownership, the IMF was considering incorporating civil society, and providing a menu of options rather than one “Washington consensus”. The goal was to secure public input and come to the fall G7/IMF meetings with a formal proposal.

The IMF also sought to become a centre of excellence on the financial sector. It worked on early warning, indicators of vulnerability, and incremental strategies to see just where tipping points might be in a world where psychology was key. Transparency remained very important, in part because it reduced the propensity for crisis and thus reinforced the IMF's crisis prevention agenda.

One final issue the IMF had to face was financial abuse and tax havens. The French, with high taxes at home that its citizens were eager to avoid, had long been livid about the abuse of the financial system, money laundering, tax havens, and offshore financial centres. They mobilized the international community, and took the FATF 40 recommendations out from the obscure margins of the Organization for Economic Cooperation and Development (OECD) onto centre stage of the G7 agenda and action. With France pushing hard, all G7 members bought in, and got the IMF involved. When O'Neil entered office he threatened to reverse the long-standing supportive U.S. policy on this issue. O'Neil asked: "why should the Bush administration protect high tax countries, as it was dramatically lowering taxes at home?" His instinctive preference was that France should reduce its taxes too, rather than persecute America's small Caribbean neighbours such as Antigua and Barbuda for having low tax rates. Yet he readily acquiesced in the G7 and FATF's decision to place three countries on a public list, with a timetable, for instituting reforms or facing sanctions if they did not. At the same time, the ongoing struggle over competing approaches would likely continue into Genoa. As much of the money into these havens came from OECD countries, there was a strong argument for dealing with the problem at the source.

The G7 at Rome, July 7, 2001

By the time the G7 Finance ministers met again, ten weeks later in Rome, the rising market challenge had again intensified, even as the U.S. political assault had diminished further. Although U.S. indicators remained mixed, it was clear that the succession of major interest rate cuts by the Federal Reserve, the prospect of a soon-to-arrive US$1.4 trillion tax cut and lower energy prices had not brought a quick U.S. recovery and would not any time soon. Moreover Japan, with negative growth in the first quarter and almost certainly lower growth in the second, had slipped back into recession, for the fourth time in a decade. And it had done so before its new Prime Minister's tough bank write-off and deficit-cutting strategy had even begun. Finally, led by its motor Germany, followed by number two France, Europe showed signs of serious slippage, to the point where some respected forecasters suggested that even a recession might be in store. Even more ominously, the ravages experienced by US new economy companies had finally come to Europe, bringing massive decreases in corporate earning, in layoffs and in share prices in their wake. The Euro followed suit, dropping to near historic lows.

The first consequence of this common downward movement was a plea by the U.S. Treasury Secretary for help from his G7 partners. It came in the form of a revival of the locomotive theory that had flourished during, and died after, the initial years of the G7 in the 1970's. Clearly recognizing the US and G7 responsibility to ensure growth in the global economy as a whole, O'Neill argued that the U.S. had acted to meet this objective through its interest rate and tax cuts. It was now time for Europe to do the same, implicitly led by a European Central Bank that had steadfastly refused to lower interest rates even as the Euro continued to fall. On the eve of the Rome meeting, O'Neill's plea earned a harsh retort from French Finance Minister Laurent Fabius, who blamed the global slowdown squarely on the United States. With a negative US jobs report and news of major new layoffs in Europe in the days before the Rome meeting opened, the mood for the meeting was grim indeed.

During and after the meeting, however, it was the sense of "hanging together" rather than disagreeing over who was to blame, that prevailed. Led by the US and the French, all G7 Finance ministers, following the briefing notes the Italian hosts had thoughtfully prepared, proclaimed that all countries and continents must do their part to strengthen growth. Led by O'Neil's promise that the U.S. was bound to return to 2% growth in the fourth quarter and 3% in the first quarter of the following year (compared to 1.2% in the first quarter of 2001), they all sounded a note of cautious optimism. The only discordant note came from British Chancellor of the Exchequer, Gordon Brown. He mused that conditions might get worse before they improved. Yet on all other items of their agenda, the public mood of G7 solidarity and confidence prevailed. While concentrating on preparing reports for their leaders for Genoa on the IFI's and financial abuse, G7 finance ministers took two concrete structural steps (G7 2001c, G7 2001d). They asked independent experts to explore structural reforms in each of their countries. And they called for a new round of multilateral trade liberalization to begin.

Yet just as the G7 succeeded in meeting its internal political challenge, its external economic one threatened to spin out of control. For immediately after the meeting, reports of an impasse between Turkey and the IMF, and of provincial resistance leading Argentina to miss its deficit cutting targets, led markets in emerging economies to plummet, and, more ominously, those in Eastern Europe, led by Poland to catch the contagion.

Prospects for Genoa

It was thus clear that, despite the demands of those on the streets for a socially-oriented Genoa Summit, led by a spending assault on HIV/AIDS, there was an ample set of urgent hard core financial and economic issues that it would be difficult, and risky, for the G7 leaders to avoid. Four stand out.

Global Growth Prospects

The first is the continuing concern with global growth prospects. By July 20 the US slowdown will be entrenched, with more people laid off. The US will have dropped from 5% to under 1.5% growth, representing an enormous decline that becomes more psychologically consequential with each passing month. Unemployment moving upward from 4.5% and drops in the stock markets would have a real economic effect throughout middle America, as Americans hold off on large purchases and become concerned about credit card debt. The return of 1970's like "stagflation" in Europe will be a major issue at the Summit as well, particularly in view of its heavy electoral effects.

Emerging Market Situation

By the time of the Genoa the pattern of growth in Argentina and Turkey will be clear. The G7 could have a major problem in other emerging markets if these two countries have not returned to sustained growth. Hence the G7 will discuss these and other pivotal cases, and the condition of Russia. Russia, while doing well in the short term as rising energy prices boost GDP, continues to have long-term structural problems, especially in regard to taxation, corporate governance, and widespread corruption. It also suffers from capital flight of US$20 billion a year, sums which the G7 and IMF no longer are willing to finance.

New Trade Round

The G7 leaders at Genoa, following their finance ministers in Rome, will, importantly, support a new trade round. There will be discussions about how to move forward at Qatar. The momentum in the G7 is very strong. At a high political level, the G7 will pledge an "early and fruitful" launch. The IMF will mobilize developing countries to realize that liberalization is key.

IMF Reform

The G7 at Genoa will welcome continuing reform of the IMF. It will take stock of the ongoing reform effort. There is widespread satisfaction with the work to date. By the end of July there will be public input, and indications of IMF staff views at the most senior levels. Several new senior level appointments at the IMF will set the direction. There will be progress on crisis prevention and early indicators. The G7 will ask for more work, and the IMF will deliver.

Conclusion

At the Genoa G7 leaders meeting, perhaps the greatest drama will be whether the collective harmony easily reached among the new and old incumbents at the ministerial level will flourish as fully among the heads of state and government themselves. Despite his inexperience in international and financial affairs, President Bush, during his first months in office, gives firm evidence that they will. If so, this will be no small triumph, for it is rare to have so many newcomers, all from such a different part of the political spectrum, arrive in the G7/8 all at once. In addition, having the host country government change so close to a Summit is rare. While Berlusconi hosted Italy's last G7 Summit at Naples in 1994, it has taken some time for him to assemble a cabinet.

Even with this G7 inexperience and political shift, it is clear that the prospective failures and disappointments of the recent past are not ideological but intellectual in nature. The G7 has coped easily with the challenge of absorbing a new right-ward oriented U.S. administration whose leaders and treasury secretary had little experience in international economic affairs, even as it simultaneously had to socialize similarly predisposed and configured new governments in number two Japan, host Italy, and always relevant Russia. Yet it has been less successful in meeting the external market challenge through innovative new approaches or actions to govern an international financial system in the process of profound change. To be sure there has been some forward movement, as with the new emphasis on crisis prevention and the move to development strategies for a post-HIPC era. Moreover, some of the old ways, as in the rescue packages for Turkey and Argentina were arguably necessary to avert larger disasters close at hand. But some of the continuities, notably the bipartisan Clinton-Bush love affair with the CCL, have been poorly tailored to meet systemic needs. Some issues, notably exchange rate management, have been deferred. And there remain real questions as to whether the IMF at the heart of the old international financial architecture can adapt quickly enough.

It is thus clear, as Robert Mundell has recently recognized, that the world must look not to the old IMF to reinvent itself as part of the new international financial architecture needed for the future, but to the G7. As the concert equality models explains, as an international institution it is certainly up to the task of socializing internally large and potentially ideologically rogue member states into new collective concepts of their interests and even identities, and inducing collective commitments and compliance. Yet the paradox is that the concerts are a particularly conservative form of international institution, much better at satisficing to avoid disaster and maintain the existing order than operating in optimizing fashion to innovatively pioneer new principles and processes in response to a rapidly changing world. The ultimate challenge for the G7/G8 at Genoa, and beyond, is to find a formula to reach beyond the constraints of its deep structure as a concert and create, conceptually and concretely, the new international financial architecture that a globalized world now needs.

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