The Implications of the G20's London Summit for International Banking

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Introduction

The Group of Twenty (G20) systemically significant countries has come a long way since it sprung to life at the level of finance ministers and central bankers in 1999, in response to the Asian-turned-global financial crisis of 1997-99. As it approached its tenth anniversary of annual autumn meetings in November 2008, the much more devastating American-turned-global financial crisis led the G20 to leap to the leaders level, with its first summit in Washington DC on November 14-15, 2008, its second in London on April 1-2, 2009, and its third prospectively in New York City at the end of September 2009. At the same time the G20 has added more finance ministers meetings, with an ad hoc gathering on the margins of the meetings of the G7, International Monetary Fund (IMF) and World Bank in Washington in October 2008, a preparatory meeting for the London Summit at Horsham, England, on February 14-15, 2009, and another gathering on the margins of the semiannual G7–IMF–World Bank meetings on April 24, 2009.

What have all these meetings meant for the global economy in general and the increasingly interconnected financial and banking industry in particular? The short answer is "a great deal" and in ways less problematic than many had first feared. The G20 summit-led system is emerging as an effective centre of global financial governance in a way that the old G20 finance ministers forum, and even the annual G7/G8 summits starting in 1975, seldom were. With the predominance of global economic power of the G20, its growing internal equality between established and emerging economies, and its direct control by national leaders, it is well endowed to make a difference in the real economy and to all the major stakeholders there. Its core mission of securing financial stability in an era of intense globalization and escalating crisis makes it well suited to meeting the urgent demand for this critical global public good. But today's G20 summit institution is much newer, less compact and more diverse than its G7/8 grandparent. Moreover, it has been born into a world where there are far more international institutions and inter-institution competition than there was when the G7 was created in 1975 or the Bretton Woods bodies were born in 1944. When the unprecedented nature of the current crisis is added, it is remarkable that the G20 summit has accomplished so much in such a short time. It is likely to accomplish more in the months and years ahead.

Before the London Summit: Competing Approaches to Different Crises

The G20's second summit in London on April 1-2, 2009, centred on an agenda and approach largely defined by the very detailed communiqué produced at its first summit in Washington on November 14-15. Both contained a core agenda of five items:

- growth of the global economy through fiscal and monetary stimulus;
- regulation and supervision of the financial system and industries where the current crisis was thought to start;
- reform of international financial institutions (IFIs), notably the IMF, World Bank and the Financial Stability Forum (FSF);
- trade and investment liberalization, by preventing protectionism and delivering the long overdue Doha round of World Trade Organization (WTO) negotiations; and
- development through expanding resources available to poor countries through the IFIs.

By the time the leaders arrived in London, British prime minister Gordon Brown as G20 chair and summit host had succeeded in adding two others items: the issue of jobs, training and social inclusion, at the microeconomic level, and the issue of climate change.

To develop the details on the basis of the principles, timelines and targets set at Washington, four working groups were established, each with one co-chair from an established member and one from an emerging economy. The group on financial regulation was co-chaired by Tiff Macklem, associate deputy minister of Canada's Department of Finance, and Rakesh Mohan, deputy governor of the Bank of India. On the way to London, a fifth working group was added to focus on employment.

In the lead-up to London, the great drama that was played out publicly and to some extent privately was which of two agenda items would dominate: would it be growth, with the United States under its new Democratic president Barack Obama pushing for fast, simultaneous, international fiscal stimulus, or would it be financial regulation, with continental European leaders led by France and Germany demanding strong, even supranational, regulation of all financial industries, with particularly harsh measures against tax havens and hedge funds. Brown, as chair in the transatlantic middle, had to balance both in order to produce a reasonable result.

The outcome of this debate, in this club of 20 equals, was driven in the first instance by the positions of the many other members beyond the Euro-American dualists. Within the G7 club, Japan — the world's second most powerful country — had a strong need for new fiscal and monetary stimulus but none at all for new financial regulation. Italy, where the banks were intact at the time, was much the same. So was Canada, where the growth situation and prospects looked better than America's and where the financial system — beyond one small, long-standing problem with non-bank asset-backed commercial paper — remained in sound shape. Independent analysts regularly confirmed how good Canada's banks were on a global scale.

Canada's comfortable position at the time was, and still largely is, based on several factors, as follows:

1. The first was a resilient economic structure composed of several pillars, most of which were in reasonably good shape. Commodity demand and prices had a floor in oil, gold, agriculture and uranium, and would return elsewhere when global demand rebounded in minerals and coal. Information technology, led by Research In Motion's BlackBerry, continued to expand sales in global markets and employment at home. The automotive industry, although in deep difficulty in assembly, had several tier-one parts suppliers, led by Magna, that were relatively well positioned for what was to come.

2. The second factor was a government sector that had led the G7 for several years in running budget surpluses since 1997 and that was steadily reducing its now modest debt burden as a result. Virtually all of Canada's provincial governments had followed the federal lead. As a result, the federal fiscal stimulus of CA$40 billion, which came on January 27, 2009, was manageable and modest, as it was backed by provincial stimulus action and by automatic stabilizers (including a secure public pension plan) that more similar to Europe's than to America's. Together the trilogy produced a stimulus of 3.5% of gross domestic product (GDP).

3. The third factor was a central bank with strong inflation-fighting credibility, and thus an ability to drop policy interest rates to close to zero with no adverse inflationary effects. It also later equipped itself with the power to engage in unconventional monetary policy, but did not need to use most of these new tools. Canada still had much more fiscal and monetary policy ammunition to shoot than its G8 partners had.

4. The fourth factor was a housing and commercial property sector without serious problems. Unlike America, Canada never deducted mortgage interest from personal income taxes, never had non-recourse mortgages and had almost no 40-year mortgages or subprime loans. Unlike America, Britain, Ireland or Spain, Canada never had a housing boom to go bust.

5. The fifth factor was a banking sector that was big, boring and bolstered by excess capital and by a reliable domestic retail deposit base. The latter helped protect those three of the five big banks with substantial operations in the U.S., including the Royal Bank of Canada, Toronto-Dominion Bank (TD) and the Bank of Montreal (BMO). Canada's most international bank, Bank of Nova Scotia (BNS), was buffered by having few U.S. operations, several elsewhere in the relatively stable Americas and Asia, and the hard lessons learned in Argentina a decade before. Canada's banks soon bolstered their capital by issuing preferred shares and loaning more, at government urging, to help offset the contraction in loans from other sources abroad and at home.

6. The sixth factor was a compact regulatory club, whose heads can all fit into a single taxi cab. Communication and co-operation were easy and routine.

In their financial sectors, most of the G20 countries looked — and, other than Italy, still look — far more like Canada than they did and do the traditional, now deeply troubled, big three of America, Germany and Britain. China and India in Asia, Brazil in the Americas and South Africa in Africa saw no need to change their well-functioning banking and financial regulation and supervision, especially if they would be told what to do by the so-called experts from America, Britain and continental Europe, where banks were going bust. When Canada had started its last Financial Sector Assessment Program (FSAP) review, its friends from the United States complained how Canadians were behind the times in adopting America's finest financial innovations, such as credit derivative obligations (CDOs), structured investment vehicles (SIVs) and other structured finance mechanisms. They were right: by the end of Canada's assessment, as the crisis was starting to break, complaints about Canada's banks being boring and behind the times had disappeared.

The vast majority of the G20 members thus saw no need for the London Summit to give priority to financial regulation, let alone strengthen it in more statist, supranational ways. The emerging members of the G20 needed, above all, restored growth in export markets through stimulus, unfrozen trade finance and a halt to protectionist measures everywhere. They also wanted to reform the IFIs to get the greater voice and vote they deserved, to have them help the developing countries they identified with, and to avoid climate change measures with the protectionist and growth-dampening dangers it brought potential.

At the London Summit: Achievements and Ambiguities

What the emerging economies most wanted at London, they largely got. On growth, the leaders agreed to do whatever it took by adding new fiscal and monetary stimulus in the years ahead. On IFI reform, they agreed to add all G20 members and Spain to a renamed and strengthened Financial Stability Board and to hasten efforts to complete the next round of voice and vote reforms at the IMF and the World Bank. On trade, they again took the anti-protectionist pledge, now with Obama on board, and asked the WTO and others to publicly monitor how their promises were being kept. On development, they added US$1.1 trillion, a staggering sum that would also help global stimulus as a whole. On climate change, they made a modest start by endorsing the United Nations Copenhagen conference in December and by shifting their national policies toward the idea of green stimulus.

On financial regulation, the results reflected the approach of the many who saw little problem for them at home. For the changes endorsed were far less strong, statist, supranational and speedy than some had wanted and more had feared.

First, the fundamental principle affirmed was effective regulation, based on market principles, to restore lending and rebuild trust and confidence. The test was regulations that worked, with market participants as the ultimate referee. This was remarkably a light-touch approach. Absent were any demands to punish those responsible for past problems or to ensure that similar problems would not happen again. The singular concern was with putting out today's fire rather than building a better fire hose, or a better fire station, to cope with future fires.

Second, restoring domestic lending was essential for fiscal and monetary stimulus to work to restore growth. Thus, in addition to addressing the existing provision of liquidity, recapitalization and impaired assets, G20 governments would take "all necessary action to restore the normal flow of credit through the financial systems and ensure the soundness of systemically important institutions." This was an affirmation of the central message of Canadian finance minister Jim Flaherty and an encouragement to a slow-moving America, which had put stimulus first, to get on with the essential banking system reform.

Third, credible exit strategies were called for. This was a sign that the G20 recognized the dangers of financial protectionism and was already looking ahead to lending and trust being restored. It thus anticipated the current call in America by Goldman Sachs and J.P. Morgan to be released from the government's control grip.

Fourth, there was a demand for domestic regulatory systems that were not only strong but also — and especially — internationally consistent, through internationally agreed high standards. The emphasis was more on the horizontal need for international consistency and co-operation than on the vertical level of regulation or supervision itself. This would be done in ways that, *inter alia*, supported "competition and dynamism."

There followed a list of nine more specific decisions. Of these three stand out.

Hedge funds would be subject to regulation and supervision only if they were "systemically significant." They were thus subjected to the standard "all in" principle, rather than being singled out for special treatment as especially pernicious. This was a far cry from the demand of some consequential Germans and Italians to abolish them outright. America and Britain won here.

On tax havens, the second core demand of the continental Europeans, the G20 boldly proclaimed "the era of banking secrecy is over." But all the G20 promised was to "stand ready to deploy sanctions" rather than actually unleashing any. The winner here was China and the other G20 members such as Britain and Canada, with tax havens of their own in the Caribbean and elsewhere to protect.

On accounting, the call was for standards setters to work urgently with supervisors and regulators to devise an internationally consistent regime of high standards. G20 governors thus refrained for ordering independent professionals how to practise their specialized and complex craft.

After the London Summit

The G7/G20 Finance Ministers Meetings on April 24

After the London Summit, the debate continued over hedge funds and accounting and added banking stress tests and standards, in the lead-up to and through the G7 and G20 finance ministers meetings on April 24. In their communiqué, the G7 finance ministers overwhelmingly and directly endorsed what the G20 leaders had done three weeks earlier. The G20 meeting lasted less than two hours and was co-chaired by Britain's chancellor of the exchequer Alistair Darling and America's treasury secretary Timothy Geithner, and did not produce communiqué. Here the focus was on setting priorities to implement the many commitments made by the leaders at London. It was also on global growth, in the immediate wake of the IMF's new, gloomy forecast that the global economy would contract by 1.3% in 2009.

At both meetings France's Christine Lagarde sought to move to specifics, notably to define the actual systemically significant hedge funds. The Europeans also disputed the methods behind the IMF's estimate that there were US$4.1 trillion of bad assets on the books of the world's banks, with those in Europe being more burdened than most. Yet all seemed to agree that America was now moving with sufficient speed and skill to take care of its banks' impaired assets, thus meeting the essential prerequisite for global recovery to begin. No demands for more intrusive banking regulation were voiced or even hinted at.

Implementation, Compliance and Effectiveness

The good mood at the meetings was sustained by the fact that the task of implementing the broad and deep London commitments seemed to be proceeding rather well.

On growth, Japan unveiled a major new program of fiscal spending, following its major stimulus in 2008. Lagarde said she too would stimulate again if need be. Flaherty signalled that he would if necessary. And the G7 again promised to stimulate as much as was needed, to restore growth from the green shoots they now saw.

On regulation, immediate action was taken on tax havens, with all of the three countries remaining on the blacklist issued by the Organisation for Economic Co-operation and Development (OECD) falling in line. This suggested there would be no need for any sanctions to be unleashed.

On trade, the World Bank's report for the April 24 G7/G20 meetings noted that in the three weeks since the London Summit, nine G20 members had violated their anti-protectionist pledge. But this list included measures being "considered" as well as actually taken. And four countries had taken liberalizing measures during this time. This record was better than the period following the G20's Washington Summit.

On development, there was steady progress. As part of the headline US$1.1 trillion pledge, Japan, America and Europe (including Britain at US$15 billion and France at US$16 billion) had each promised US$100 billion for the IMF. Canada pledged CA$10 billion, its traditional 10% of America's contribution. But China seemed to back off its early signal to give US$40 billion. The Russians and Saudis remained resistant to giving anything at all. They looked to the alternative, approved in the London communiqué, of having the IMF float bonds instead. Amidst the debate, only Canada said it would consider giving more if the IMF asked.

Prospects for the September Summit

These developments provide a basis for judging what lies ahead for the third G20 summit, very likely to be held in the United States at the end of September this year.

First, growth through fiscal stimulus will be at the centre. The demand for further stimulus will arise — as evidence for real recovery, rather than merely green shoots, remains rather rare. The doubts that fiscal stimulus works economically have been put to rest by the Koreans, whose large and very green stimulus helped their economy grow in the first quarter of 2009. Evidence that fiscal stimulus works politically has just come from Japan, where Prime Minister Taro Aso's latest package has helped give him a badly needed boost in the polls. It will be hard for G20 leaders to run from their "all necessary measures" promise, now repeated in the G7 communiqué, as Lagarde and Flaherty's recent comments attest. And the U.S. Congress will find it easy to spend, especially as its mid-term elections approach. With elections in Japan in late August and in Germany in September, the leaders of these second- and third-ranked economies will find it easier to get into the stimulus game (see Appendix).

Second, **regulation** for banking and finance will be put on the backburner. The London summiteers gave themselves until the regular G20 finance ministers meeting, in Scotland in November, to get the London-initiated work done. They and their ministers and officials thus can take the time they need to get it right, and to allow the passions of the moment to dissipate, for example over executive pay, bonuses and Bernie Madoff. Diminishing as a result will be any political lynch mob mentality and precipitous rush to regulation, Sarbanes-Oxley-style. Moreover, in Scotland Britain will again be in the chair, with the prerogatives and responsibility as a host to help ensure that the results are faithful to the general guidelines set by its London Summit. And by November there will be no elections to replace the Brown-Darling team, and its majority government, with others of a different political bent.

Third, trade will be less prominent. The anti-protectionist guard will not be relaxed as the fear of fascism bred by the protectionism of the 1930s is the dominant historical memory that most G20 leaders bring. But with few signs of any protectionist spiral, and with more green shoots sprouting, a replay of the 1930s seems unlikely to break out. Doha will drag on for yet another year, while developing countries will now have direct money to compensate for the absence of the stimulus that multilateral trade liberalization brings. And in North America Obama has abandoned his potentially protectionist pledge made during the election campaign to reopen the North American Free Trade Agreement to strengthen labour and environmental provisions. Only green protectionism, starting with California's carbon regulations and Obama's cap-and-trade climate change control plan, will arise as a real protectionist threat.

Fourth, China could surface as a comprehensive, active and visible player. At London it took largely a single-issue and defensive stance, intervening to protect what some saw as its tax havens in Macau and Hong Kong. But by September, as the January 2001 deadline for completing the voice and vote reforms draws closer, China will want to show that it is ready to accept the new responsibilities that go with its greater rights.

Fifth, America's agenda and approach will prevail. New York will be President Obama's first serious outing as a global summit host. As London showed, at these summits he listens, learns, mediates to break log jams (as with China on tax havens) and brings his still internationally strong star appeal to bear. The probable result for New York will be more G20-approved emphasis on fiscal stimulus, social inclusion, income equality, jobs and climate change control.

The Longer-Term Future

In regard to the longer-term future of the G20 summit as an institution, three conclusions seem clear.

First, G20 summitry will continue — it is here to stay. The crisis that created it and the searing scars that the crisis brought will not soon fade away, nor will the G20 summit's promise to prevent the next crisis. This task can no longer be left to mere ministers as in 1999, as the outbreak and devastation of the current crisis has shown. G20 leaders will probably meet less frequently, as the scheduling and other difficulties in arranging the third summit suggest. One possibility is that they will follow the example of the Asia Pacific Economic Cooperation frum and add a leaders' event to their annual autumn ministerial meeting. But G20 summitry is destined to live on indefinitely, at least as an annual event.

Second, the G20 will operate as a genuine club of equals, rather than one where the established G7 powers dictate to the emerging G20 ones. This was the dynamic that produced the results at London. And the emerging economies will retain their real leverage on key G20 issues, such as new IMF resources for development, trade liberalization and climate change control. Here it is worth recalling that the G7 and G8 created the G20 at the level of finance ministers and central bankers in 1999. They did not create the G20 at the summit level in 2008. By then an afflicted America rationally recognized from the start that it needed help not just from the G8 but from all its G20 friends.

Third, the G20 summit will co-exist with the "G8 plus" for some time still. Each has a distinctively different core mission, agenda and schedule. The G8's hosts are reluctant to give up their chance to shine in the global limelight once every eight years. Yet as both groups move to share a concern with climate change, development and trade, it will be necessary to define the relationship between the two, in the overall task of global governance.

Appendix
Elections in G20 Countries

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Member	Most Recent Election	Next Election
Argentina	October 28, 2007	2011
Australia	November 24, 2007	On or by April 16, 2011
Brazil	October 29, 2006	October 3, 2010
Canada	October 14, 2008	On or before October 15, 2012
China	March 15, 2008	2013
France	April 22 and May 6, 2007	2012
Germany	September 18, 2005	September 27, 2009
India	2004	Now underway to May 13, 2009
Indonesia	September 20, 2004	8 July 2009
Italy	April 13-14, 2008	Variable
Japan	September 11, 2005	By October 2009
Korea	December 19, 2007	2012
Mexico	July 2, 2006	2012
Russia	March 2, 2008	2012
Saudi Arabia	Not applicable	
South Africa	April 22, 2009	2014
Turkey	July 22, 2007	Variable
United Kingdom	May 5, 2005	By June 3, 2010
United States	November 4, 2008	November 2012
European Union	June 10-13, 2004	June 4-7, 2009