Columbia University's APEC Study Center and
Program in International Finance and Economic Policy, School of International and Public Affairs

# Assessing the G-20 Results: Regional Perspectives

April 7, 2009

## Sharyn O'Halloran

George Blumenthal Professor of Political Economy
Professor of International and Public Affairs

## Guillermo Calvo

Professor of International and Public Affairs
Director, Program in Economic Policy Management

## Padma Desai

Harriman Professor of Comparative Economic Systems; Director, Center for Transition Economies

## Arvind Panagariya

Jagdish Bhagwati Professor of Indian Political Economy; Professor of Economics

## Richard Clarida

C. Lowell Harris Professor of Economics and International Affairs

*Moderated by*

## Merit E. Janow

Professor, International Economic Law and International Affairs; Director, Program in International Finance and Economic Policy

# Assessing the G-20 Results: Regional Perspectives

On April 7, 2009, six distinguished professors from Columbia University's School of International and Public Affairs provided insight on the regional impact of the April 2009 Group of 20 (G-20) Finance Ministers and Central Bank Governors meetings in London. Participants included Sharyn O'Halloran, George Blumenthal Professor of Political Economy and Professor of International and Public Affairs; Guillermo Calvo, Professor of International and Public Affairs and director of the Program in Economic Policy Management; Padma Desai, Harriman Professor of Comparative Economic Systems and director of the Center for Transition Economies; Arvind Panagariya, Professor of Economics and Jagdish Bhagwati Professor of Indian Political Economy; and Richard Clarida, C. Lowell Harriss Professor of Economics and International Affairs. The panel was moderated by Merit E. Janow, Professor of International Economic Law and International Affairs, director of the Program in International Finance and Economic Policy, and co-director of the Asia-Pacific Economic Cooperation (APEC) Study Center.

Professor Janow began by giving some background on the G-20, which was formed in November 2008 when the format was expanded from the G-8 to include several additional nations. Now encompassing almost 85% of global GDP, the G-20 is significantly more inclusive and representative than its predecessor.

Professor Janow then relayed some opinions regarding China's role in the G-20 from Professors Shang-Jin Wei, N.T. Wang Professor of Chinese Business and Economy, and Daniel Rosen, adjunct associate professor, who were unable to attend the panel. Both had emphasized the significance of China's central bank governor questioning the safety of the U.S. dollar as the world's reserve currency. To this end, the Chinese offered alternatives to the greenback, such as expanding the use of Special Drawing Rights (SDRs), a synthetic currency that the IMF uses to extend credit to partner nations. Professor Wei had also indicated that he expected the Chinese to press strongly for a larger role in the IMF. Professor Rosen thought that the summit presented China the opportunity to be more assertive about its role in shaping the international financial system.

Professor **Sharyn O'Halloran** opened the panel by discussing how precipitously the United States economy has declined since the beginning of the financial crisis. She cited a 40% reduction in trade and huge declines in GDP growth, calling this situation a "huge time of global structural adjustment." Although this adjustment is most pronounced in advanced industrial nations like the United States, O'Halloran said that it is also occurring in developing countries, as indicated by the broad global decrease in industrial production and trade. This is especially hurtful to developing countries, as globalization has increased their trade as a percentage of GDP.

O'Halloran offered two examples of this discrepancy. In Germany, international trade declines are responsible for 14 percent of the GDP loss. Meanwhile, China has experienced a 40 percent decline in trade, which could signal a harbinger for huge declines in GDP since 75 percent of the economy is related to international trade. The net result, said O'Halloran, is a dramatic decline in both capital and manpower resource utilization. The political economy effects of this trend are alarming, as it creates incentives for national governments to engage in protectionism. Mexico is one such example, looking to raise tariffs by 10 to 45 percent on 90 goods from the United States. In addition, O'Halloran remarked that countries have been increasing subsidies in key sectors, such as the auto industry, which will further choke international trade, especially if there is significant retaliation.


Professor O'Halloran then spoke about the United States' perspective of the summit. Its primary goal was to build confidence and demonstrate that its stimulus plan is viable, and that it is serious about addressing the financial crisis head-on. In addition, it needed to show a commitment to global cooperation, specifically in the coordination of monetary policy among central banks. Finally, it wanted broader cooperation on fiscal policy – thereby creating a prime opportunity for emerging markets and large participants in the world economy, such as China, Brazil, and India to take an active role in reshaping the rules of the global economy.

A further goal of the G-20 meeting was to strengthen international organizations like the IMF and the World Bank. Professor O'Halloran believes achieving this goal is crucial in order to mitigate the impact of the global recession on emerging markets, and she noted that there was some success to this end. A total of $1.1 trillion was pledged to recapitalize the IMF, including $100 billion in loans to developing countries and $250 billion in credits to fund international trade. This is a particularly important component because the lack of trade financing during the recent credit crunch is largely responsible for the contraction in trade. The G-7 nations also made political concessions to China, India, and Brazil, promising future discussions regarding additional voting rights within these multilateral organizations. O'Halloran also spoke about the creation of a financial stability board, which is an improvement on the existing financial stability forum to monitor systemic risk internationally. The new body now has more discretionary powers in assessing and stabilizing risk.

Professor O'Halloran closed with some overarching goals that the G-20 would be wise to focus on. The first is maintaining global trade, which is currently under threat. The World Bank reported that after the G-20 meetings, 17 of the 20 countries imposed restrictive trade policies, which should be reversed. The second is supporting emerging market development, since bringing in a large number of consumers into the world market is imperative for re-energizing growth. Fortunately, O'Halloran sees some initial signs of recovery, especially in credit markets. The TED spread, which is the difference between interest rates on interbank lending and U.S. treasuries, and serves as a measure of credit availability, has narrowed to a more normal level. Mortgage rates in the United States have fallen below 5 percent, making home buying affordable again. There has also been increased activity in manufacturing purchases, which lead industrial production.

Finally, Professor O'Halloran said that timely economic recovery is contingent on fulfilling the G-20 commitment to harmonizing global fiscal and monetary policy. She believes this is necessary in order to provide global liquidity for trade until the recession is over.

Professor **Guillermo Calvo** then gave Latin America's perspective on the G-20 meetings. He believes that with the expanded G-20, there has been a fundamental change in how world leaders deal with economic crises. For example, during the 1995 Mexican "tequila crisis," the international community put together ambitious bailout program costing $50 billion, yet it differed in two ways from the strategy of confronting the current crisis. First, much of the support was pro-cyclical, exacerbating the downturn in the short-term. Second, help did not come until output in Mexico had already fallen by 6 percent. Today, Mexico is also receiving close to $50 billion through the IMF, but these sums are being put to use before the country experiences a large drop in output. Additionally, these measures are anti-cyclical, helping to smooth out fluctuations in the economy.


Professor Calvo then spoke about the increased lending from the IMF, namely through the revamped Flexible Credit Line (FCL), which has total assets of $750 billion for global lending. According to the Inter-American Development Bank (IDB), the need in Latin America alone for the next 2 years is more than $400 billion.

Professor Calvo then identified some of the possible threats that may result in calls for increased IMF intervention in order to stabilize the region. One is the reversal in capital flows. Already, there has been a large retrenchment in flows to emerging markets. In 2007, developing countries were net receivers of $1 trillion. The IMF estimates this will plunge to $160 billion in 2009. Second, these countries would have trouble servicing sovereign debt, meaning that the IMF would have to fill this liquidity gap.

Professor Calvo was concerned that, against the backdrop of such a stark economic downturn, the IMF funds may not be sufficient, especially if several countries experience default events simultaneously. Although he believes most countries in Latin America will remain solvent, Calvo argued that the IMF should increase its credit line of SDRs. This would mean that the IMF would operate more like a central bank than simply a lender of last resort.

Professor Calvo also addressed the issue of financial regulation, and how new regulations could assist a new financial world order. He stressed that although there is a place for regulations, effective financial systems do not function on the basis of regulations. More important are the services rendered by institutions like central banks – substituting for imperfections in the financial system by providing services as a lender of last resort. Calvo closed with a warning not to emphasize regulations over restoring and increasing lending capacity.

Professor **Padma Desai** then discussed Russia's role in the G-20 summit. She explained how the Russian response has differed from other nations. Instead of crafting a stimulus package that would result in a budget deficit and higher inflation, the Russians instead have chosen to endure a short period of economic contraction. Professor Desai said that this is because the current inflation rate of 13 percent is too high already; any increase would lead to a loss of confidence in the Central Bank's ability to fight inflation. However, one drawback of a period of negative growth will be a fall in the value of the ruble against the dollar and euro.

With respect to the summit, Professor Desai said that the $1.1 trillion in support was essentially $500 billion more for IMF funding and $250 billion in credit availability to developing countries through SDRs. Professor Desai believes the Russian position to be essentially the same as the Chinese, that the IMF should be restructured with increased voting rights for emerging markets and that the SDR should replace the dollar as the global reserve currency.

Professor Desai also said that the financial crisis is affecting Russia differently than other nations, particularly the United States. Since the start of the Georgian war in August 2008, the ruble, along with Russia's foreign reserves, has been crashing as investors have looked to convert their local currency holdings to dollars and leave the country. In contrast, the dollar has appreciated during the financial crisis.

A second feature unique to Russia is the changing relationship between the oligarchs and the Kremlin. During the period of high growth from 2000 to 2007, the Russian oligarchs expanded their operations to take advantage of the global commodity boom. This included heavy borrowing from western banks. When stock prices declined at the onset of the crisis, and the ruble began to crash, the oligarchs were left with large outstanding loans in hard currency and declining ruble values in which to service this debt. To assist the oligarchs and big banks stuck in this predicament, President Vladimir Putin allocated $50 billion to the banks from state coffers, a snap political decision with no legislative oversight. By February 2009, however, there was a policy change; the Kremlin declared it was no longer bailing out the oligarchs or big banks, and if they failed to raise their own hard currency, they would be allowed to fail. Professor Desai believes this to be a positive development, as it could indicate an end of the incestuous link between the Kremlin and the oligarchs.

An additional policy shift, said Professor Desai, is the Kremlin allowing the ruble to depreciate through the absence of exchange controls. Overall, Desai was positive about Russia's response to the crisis and is hopeful that the progressive policies would continue.

Professor **Arvind Panagariya** discussed the relationship of India within the G-20, which he does not believe to be as substantive as for other nations. He did point out some positives of Indian participation, explaining that it has created a forum where India can participate in global discussions, which will put constructive pressure on Indian officials to maintain the reforms of the past 20 years. India has also argued, like Russia and China, for a greater role in the IMF, which gained traction at the summit because the date for the reconsideration of voting rights was moved forward from 2013 to 2011. Additionally, the $250 billion in trade credits that was approved will help India because its trade has been badly affected, like other nations. Panagariya believes that restoration of trade credit is the single most important thing that needs to happen for developing countries to rebound from the crisis. Panagariya also said that there have been some minor policy changes at the domestic level that complement G-20 action, like the tightening of tax savings laws, but nothing that will make a major difference.

Professor Panagariya then discussed how the crisis has affected India. He began with the drag on economic growth. The country had averaged 9.4 percent growth per year in the three years leading up to the crisis, but fell to 7.4 percent in 2008. Although this means that India was less impacted than many other countries, the entire contraction in GDP happened in the last quarter of 2008, falling over 5 percent from October until December. Panagariya said that there were still no numbers available for 2009 growth rates, but that exposure to the crisis can be measured by the fall in trade. The most recent monthly data available was from February, in which trade decreased by 20 percent. In fact, it has dropped every month since the demise if Lehman Brothers in September of 2008.

Professor Panagariya also said that the toxic asset problem that has plagued much of international banking has spared India, since its banks were not invested in those types of instruments. However, they have suffered the same liquidity problems as other banks. When the crisis began, investors pulled out of all emerging markets, including India, and thus created a liquidity shortage that persists. In response, the Central Bank is currently holding twice as many liquid assets as in normal times, but even with these resources to assist banks in lending, the capital markets of the country remain frozen.

Professor Panagariya then discussed the effect of the liquidity crisis on India, and how it has differed from what has occurred in the United States. In India, it began with a general economic crisis that spilled over into the banking sector, after an increase in the number of defaults on bank loans. The U.S. experience has been the opposite. Here, it began with a banking crisis that lead to a credit contraction which then spilled over into the general economy.

Indian policymakers are thus making plans to recapitalize the banking system, in addition to the $5 billion in loans from the World Bank. Professor Panagariya remains optimistic that liquidity can be restored fairly quickly once the banks are recapitalized. He predicts that India will maintain a positive growth rate in 2009, but at half of its pre-crisis level – about 5 percent. Professor Panagariya also pointed to other factors that will help mitigate the effects of the global downturn on India, including the Central Bank's use of inflation targeting and its past accumulation of foreign reserves that can be spent domestically to help growth. Additionally, the devaluation of the rupee by almost 20 percent has helped make India's exports more competitive in international markets and lessened the extent to which trade has fallen.

Although Panagariya remains optimistic about the prospects for the Indian economy, he also noted that recovery in the United States and Western Europe is essential for India to return to its pattern of 9 percent growth. When the rest of the world does indeed recover, Panagariya believes that India can maintain this level of growth for the foreseeable future.

Professor **Richard Clarida** said that, considering the history of multilateral meetings and the disparate positions of the participating nations, the progress made during the summit was remarkable. He pointed out that any substantive commitment during a G-level meeting is unusual, especially when the stakes are so high. He identified four particular areas in which there was progress: policy, regulation, international financial institutions, and especially international trade.

Professor Clarida said that there has been an unprecedented coordination in fiscal and monetary policy among nations, as well as a convergence in the regulatory patterns of many nations. Every country has undertaken measures to double or even triple the lending capacity of their domestic institutions. And although it would appear that countries are coordinating policy by cutting interest rates and other quantitative easing measures, in actuality each country is acting in its own self-interest. Clarida said that this creates a free rider problem where some countries may be more willing to engage in fiscal expansion to stimulate demand, yet the benefits may accrue to other exporting countries that do not enact stimulus measures themselves. This is particularly a problem in Europe, where some of the smaller countries may be waiting to be bailed out by the domestic stimulus packages enacted by larger countries in the region.

Professor Clarida said that there is more convergence in the area of financial regulation. Real regulation has been avoided in the past because both the United States and the United Kingdom believed that further regulation would just push business to the opposite financial center. Due to the severity of the current crisis, however, it is likely that there will be a more cooperative and substantial regulatory framework pertaining to the interest rate and credit default swap market.

Professor Clarida closed by addressing the SDR issue that had been mentioned by several panelists. He said that any attempt to move away from the U.S. dollar as the global reserve currency is futile. Talk of this by some nations is simply political posturing by developing countries that want a larger impact in the IMF and other multilateral institutions. SDRs may become somewhat more relevant, yet only as a way for the IMF to increase its lending to poor countries.

<u>Question and Answer session</u>

The first question was about whether it makes sense to re-introduce SDRs as a global reserve currency. The audience member pointed out that SDRs are simply a synthetic currency that act as a claim on a mixture of euro, yen, pounds and dollars, and that they have been relatively irrelevant since the world moved en masse to flexible exchange rates in the 1970s.

Professor Calvo answered by clarifying that he did not believe that SDRs should be used on a regular basis, but merely to creatively increase funding availability in the midst of the current crisis. Calvo was concerned that the institutions and mechanisms to provide liquidity during the current credit crunch might not be enough.

The next questioner asked why China would want to move off the U.S. dollar as the global reserve currency, considering such a move would mean a devaluation of the dollar and a decrease in asset holdings of the Chinese government.

Professor Desai answered, quoting a similar answer given by Princeton economist Paul Krugman. Krugman had said that the Chinese are at fault for keeping their exchange rate so low and therefore accumulating a massive stock of foreign reserves by accident. He had also said that the Chinese are not really worried about a decline in value of their asset holdings, or they would not have suggested such a policy shift.

Professor Clarida also answered, saying that a devaluation of the dollar was fine for China, as it fits into their development strategy. Initially, they were able to produce more goods than they could consume, and found a fertile export market in the United States. Now, they can increase their consumption and their exchange rate policy vis-à-vis the United States, eventually making China's currency regime less important.

The next questioner asked whether the dollar would still remain strong when economic growth resumes, and also requested thoughts from the panel regarding future prospects for inflation.

Professor Clarida said it was unexpected that the dollar would appreciate so strongly during the downturn. The reason was that the dollar became a safe haven instrument when all other investments were losing value. He concluded that, as economic growth resumes, the dollar will once again begin its downward trend as people move away and invest in other instruments.

Regarding inflation, Professor Clarida said that the Chairman of the Federal Reserve, Ben Bernanke, has made it very clear that avoiding deflation is the Fed's biggest priority. Although the Fed will be able to pursue this strategy successfully, finding an exit strategy will be difficult since the Fed is now so deeply involved in many aspects of the economy.

The next questioner asked Professor Clarida why there has been such an emphasis on a financial stability forum and not on strengthening existing institutions like the BASIL Accords and the IMF.

Professor Clarida replied that there has been some competition within the multilaterals for regulatory control. Professor Panagariya said that the existing institutions favor the original G-8 nations, and many developing countries would like to move outside that paradigm to gain greater input.

The next questioner asked if, assuming the crisis was caused by poor policy, it is possible that there will be a regulatory authority that will have input into G-7 policymaking in order to avoid the mistakes that caused the current crisis.

Professor O'Halloran said that the emergence of a global regulator that will manage the G-7 policies is doubtful. She envisions more coordinated policy on the regulation of G-7 financial systems. Professor Calvo agreed that there would not be a regulatory authority that had any influence over sovereign issues. He did predict that multilateral organizations like the IMF would express their views more strongly on issues of global economic policy.

The final questioner asked Professor Desai what would happen to Russia's sovereign wealth funds in the face of the country's commodity and currency declines.

Professor Desai said that there has been much internal debate about what do. The government has been cautious thus far, but there is split developing between Vladimir Putin, who is more conservative and wants to maintain ties with the oligarchs, and Prime Minister Dmitry Medvedev, who belongs to new generation of technocrats and wants to be more economically prudent with Russia's reserve funds.