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Some Advice for the G20

- The April G20 Summit will focus on four general areas: macroeconomic policy, increased financial regulation, international governance and free trade.
- While desirable, effective implementation of international co-operation on macroeconomic policy and regulation is difficult to achieve.
- We believe that more expansionary fiscal policies are needed in the developed world outside the US. That said, it is unrealistic to expect the G20 to agree on specifics.
- Despite consensus on the need for stronger international regulation, success here will depend on better domestic regulation.
- We expect the G20 to jointly propose a substantial reform of the IMF and other IFIs, paving the way for more effective policies.
- Although the G20 constitutes a major advancement over the G7/G8, ultimately it will need to be consolidated into a smaller group to be more effective. We propose the formation of a G4, within a broader G14.
- G20 leaders need to be tougher on opposing protectionism.

Many thanks to Swarnali Ahmed, Alex Kelston and Loretta Sunnucks for their skill in putting this difficult paper together in a presentable manner, and to many of my colleagues in ECS for their valuable comments, and especially Steve Strongin for our various discussions

Jim O'Neill

March 20, 2009

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Summary

- The G20 has replaced the G7/G8 as the major focal group for solving global economic and financial problems. This is a positive step.

- At the April 2/3 London Summit, they will discuss four general areas: macroeconomic policies to boost growth; increased and better international regulation for banks and the financial system; better, and more legitimate international governance; and free trade and competition.

- While international agreement and consensus are welcome, in two of the areas, macroeconomic policy and international regulation, it is difficult for this to be effective. Monetary and fiscal policies are largely the domain of domestic policymaking. The same is true for financial regulation.

- More expansionary fiscal policies are desirable outside the US in the developed world, especially in countries with high domestic savings rates. It is unrealistic to expect the G20 to agree on this.

- The G20 will announce plans for improved and more international regulation of the banking system, including an endorsement of a greater role for the FSF. They will discuss all the areas outlined above, and possibly more. Ultimately, improved regulatory success will depend on the greater effectiveness of domestic regulation.

- The G20 will agree to more funding for the IMF, and specific plans to improve its legitimacy, its voice and, therefore, its effectiveness. This is long overdue and to be welcomed. Other IFIs will also be encouraged to change.

- Ultimately, the G20 itself (which in reality embraces at least 22 nations) will need to be consolidated into a smaller group. We propose that for systematic, globally-critical issues of economics and finance, a new G4 should be the goal, consisting of China, the EU, Japan and the US. In the future, this group may need to change further. This G4 would operate within a broader G14 (the current G7 countries plus the four BRIC nations, Mexico, Saudi Arabia and South Africa).

- G20 leaders will once again state their opposition to protectionist economic policies, and express their support for free trade. However, this time they need to be stronger, both verbally and in following through, than when they made similar comments in November.

Issues for the G20

Economic	Banking	Financial Architecture	International Competition
1. Monetary policy	1. Transparency	1.Legitimacy of G6/G8	1. FX regimes and rates
2. Fiscal policy	2. Risk warning system to monitor market accounting	2. IMF reform	2. Industrial policies
3. Environmental economic policy	3. Credit agencies	3. IMF funding	3. Tariff and trade barriers
4. Imbalances	4. Regulators	4. IMF surveillance	4. Bank deleverage
	5. Capital of banks	5. World Bank's purpose	
	6. Bank capital through cycles	6. WTO	
	7. Bank compensation		
	8. Non-executive directors		

Source: GS Global ECS Research

Some Advice for the G20

The best place to start to set the scene for this highly anticipated and potentially important meeting is with a few observations about the cyclical and structural nature of the world economy.

We and others currently forecast that world GDP (at PPP exchange rates) will be negative in 2009, which is something none of us probably ever dreamt we would be forecasting. As very few will now need reminding, the current recession is severe. We forecast a decline of 1.3% in global GDP for this year. That said, like many others, we currently foresee a significant recovery to 2.8% in 2010, although this forecast lacks confidence at the moment. The weakness of our propriety Global Leading Indicator, the GLI, suggests things need to change for our confidence in that forecast to grow.

We forecast a 1.3% decline in world GDP in 2009 and, tentatively, a significant recovery to 2.8% in 2010

The current weakness of the world economy is exacerbating the shift in the balance of the world economy away from the so-called industrialised countries towards China and some of the other BRICs. As can be seen in the table below, we forecast positive GDP growth this year in the BRICs collectively, led by China and India, and expect next year to be even better. Moreover, in contrast to our GLI, our propriety leading indicators for China have improved significantly recently. China has recently overtaken Germany to become the third-largest economy, and is well poised to challenge Japan by 2010.

And while the G7 share of world GDP continues to decline, the BRICs' share continues to rise significantly. Very importantly for the success of the G20 meeting, and for the future of the world economy, this shifting pattern needs to be reflected in the effectiveness of global policymaking, and in particular the governance of the world economy. In addition to this clear relative trend, contrary to current popular wisdom, evidence remains that domestic consumption is holding up reasonably well within the BRICs. Chart 4 shows contributions to global consumption in recent years, using domestic retail sales data as the measure (retail sales are not the broadest guide to consumption, but monthly consumption data is not available in China, for example). The domestic retail sales data is adjusted into real (after inflation) terms and then further adjusted by their share of global consumption.

BRICs' share of GDP continues to climb, while the G7's share continues to decline

As can be seen, the contribution from the US shopper has declined gradually in recent years, and then plunged in 2008. In Japan and the Euro-zone, there never has been much of a contribution. Meanwhile, the contribution of shoppers in the BRICs, led by China, has continued to rise, at least until the end of 2008.

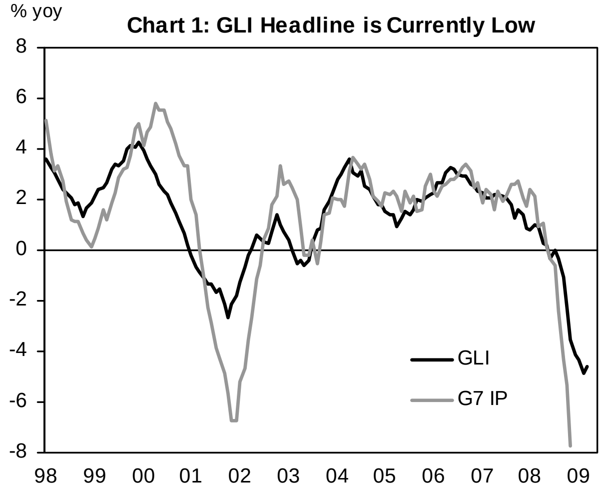
Table 1: GDP Growth: GS vs Consensus

% yoy	2007	2008	2009		2010	
			GS	Consensus*	GS	Consensus*
USA	2.0	1.1	**-3.2**	-2.8	**1.2**	1.7
Japan	2.4	-0.6	**-6.1**	-5.8	**0.1**	0.7
Euroland	2.6	0.7	**-3.6**	-2.6	**0.8**	0.5
UK	3.0	0.7	**-2.5**	-3.0	**1.7**	0.5
Europe	2.9	0.9	**-3.2**	-2.4	**1.0**	0.5
China	13.0	9.0	**6.0**	7.0	**9.0**	8.3
India	9.0	6.7	**5.8**	5.2	**6.6**	7.8
BRICs	10.4	7.5	**3.9**	4.9	**6.7**	6.9
Advanced Economies	2.7	0.9	**-3.6**	-2.9	**1.1**	1.3
World	5.0	2.9	**-1.3**	-0.5	**2.8**	3.0

* Consensus Economics March 2009

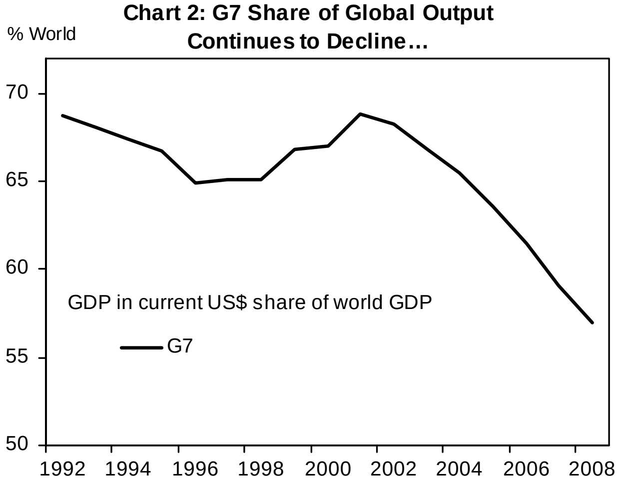
Source: GS Global ECS Research

Chart 1: GLI Headline is Currently Low



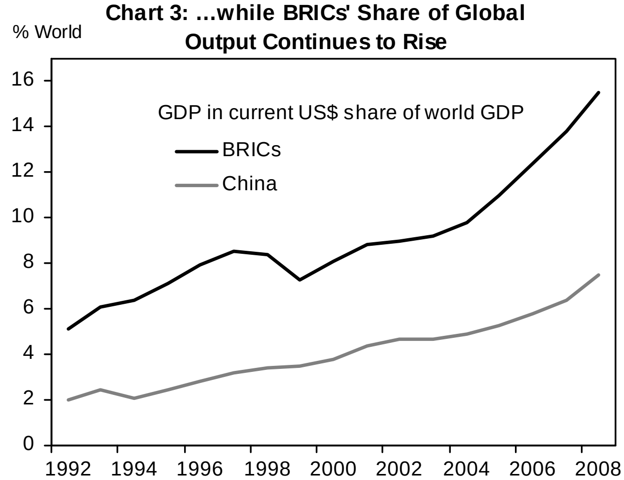
Source: GS Global ECS Research

Chart 2: G7 Share of Global Output Continues to Decline…



Source: GS Global ECS Research

Chart 3: …while BRICs' Share of Global Output Continues to Rise



Source: GS Global ECS Research

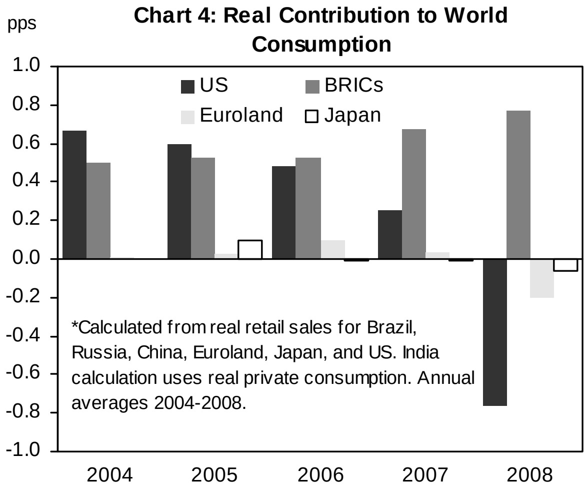
Causes and Symptoms of the Global Crisis

Against this background, it is also very important to set the scene in terms of the causes of the current world recession and the financial crisis. In much of their discussion, G20 policymakers focus on issues that are symptoms rather than the cause of the problems. Excessive risky lending by many financial institutions may well have been a key contributing factor to why we have a major credit crisis, but what economic conditions allowed or encouraged many banks to do this? We believe that there are a few key forces, all of which are inter-related. If these are not understood, then the G20 will find it difficult to implement appropriate policies to remedy the problems.[1]

G20 policymakers have tended to focus on the symptoms rather than the causes of the current crisis

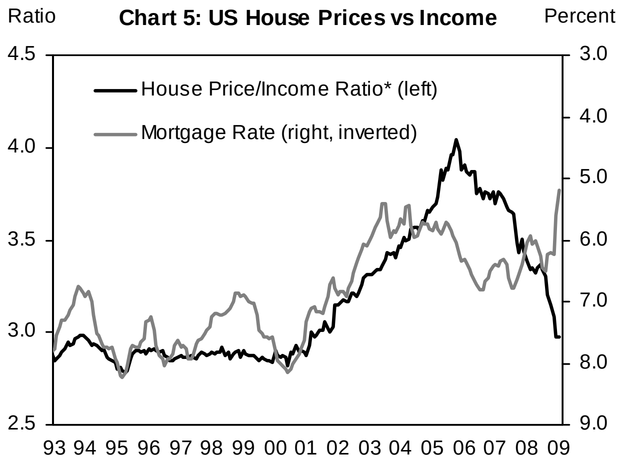
Excessive house price appreciation in the US (and elsewhere). The first, and most obvious, proximate cause of the credit crisis is the bursting of the US housing market bubble. The sharp decline in US house prices exposed the sub-prime debacle, and subsequently other weak credits exposed to a decline of the US consumer. Simply put, without the house price acceleration in the US, the US consumer would never have been able to account for more than 70% of total GDP. Now that the bubble has burst, consumption is potentially heading back towards 65% of GDP.

Chart 4: Real Contribution to World Consumption

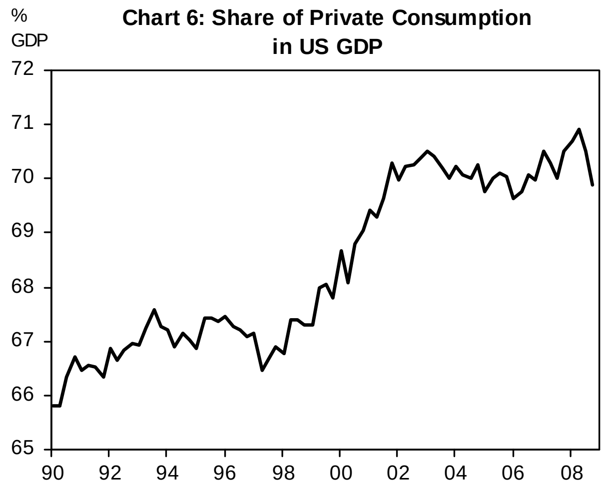


Source: GS Global ECS Research

1. Two complementary papers will soon be published by the GS Global Markets Institute: "Avoiding Another Meltdown" and "Local Rules, Global Markets".



* S.a. median home price divided by median family income.
Source: Department of Commerce. FRB. NAR.



Source: GS Global ECS Research

US savings rate too low. Consistent with this, the personal savings rate in the US is heading upwards, to between 6% and 10% of total income. As can be seen in Chart 5, the relationship between US house prices and personal income was essentially stable from 1970 to 2000, and it was only really after the new millennium that house prices started to accelerate beyond income. By 2005, house price inflation had lost any relationship to mortgage rates, a reasonable sign in our judgement that the housing market had entered a bubble. This is how the persistent rise in US consumption was possible. In turn, this is why personal savings declined so much.

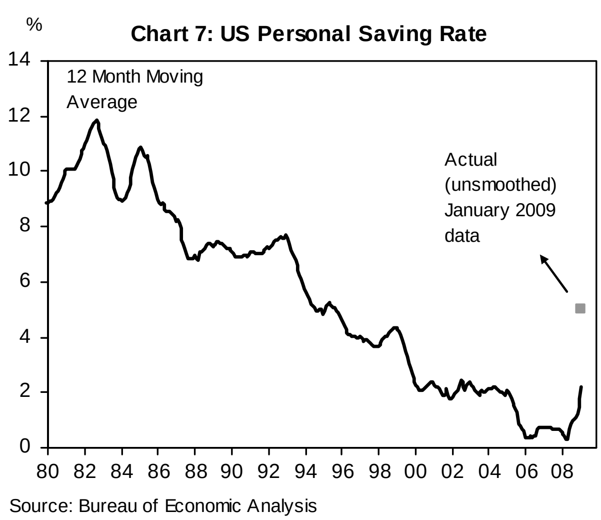
Main causes of the credit crisis were the housing bubble and the low savings rate in the US...

While other countries, including many Anglo-Saxons, experienced similar house price bubbles, the US bubble was the most important on a global basis, given that the US accounts for more than 25% of global GDP.

...as well as the rest of the world's excessive export dependency on an unsustainable US consumer...

Savings rates too high in 'excessive exporter' countries. Third, although other countries may not have had any obvious credit bubble, arguably they did have excessive export dependency on an unsustainable US consumer – as many are now seeing even bigger declines in GDP than the US.

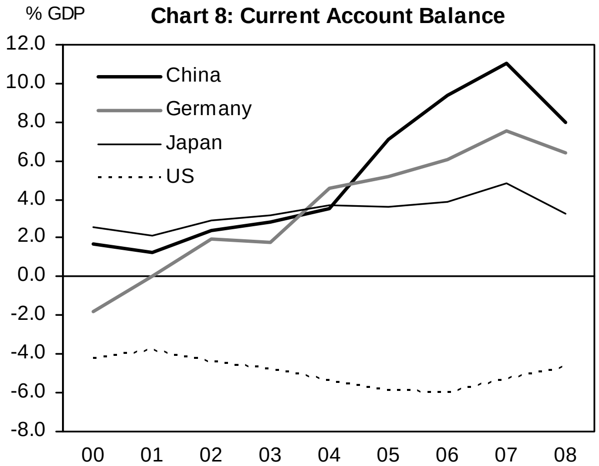
Unsustainable current account imbalances. The fourth cause links all of them together, and is something many have cautioned about for years, us included[2]: unsustainable current account imbalances. Although much has been



Source: Bureau of Economic Analysis

2. O'Neill J. and Hatzius J.'US Balance of Payments. Unsustainable, But…', *Global Economics Paper 104*, 2004 .

Chart 8: Current Account Balance



Source: GS Global ECS Research

written about unsustainable deficits, not much has been written about the unsustainability of current account surpluses. China, in particular, and to a lesser but important degree Germany and Japan, have been significant 'guilty parties'.

...all contributing to unsustainable current account imbalances

As economists are well aware, but sometimes forget, current account imbalances are simply the arithmetic difference between total domestic savings and investment. Excess savings result in net capital outflows and current account surpluses, and excess investment (or too low savings) results in net capital inflows and current account deficits. Our G20 leaders need to remember these basic economic facts.

As the subsequent economic crisis unfolds, we see encouraging signs that these major (related) imbalances are now reversing. The US current account deficit appears to be heading down to 3% of GDP or possibly lower and, as reported recently, the US personal savings rate has already risen to 5% of income, from as low as 0.6% in August 2008. In my recent *Global Economics Paper* on the outlook for the Dollar[3], I suggested that there were three different scenarios that would all lead to a lower US current account deficit: a 'bad' scenario (the current one), a 'better' one (the last 12 months) and a 'best' scenario (the last two years). The 'better' scenario, which G20 participants and the US should be thinking about, is the most desirable. In such a scenario, US savings would still rise, but most probably in circumstances in which domestic demand strengthens more outside the US, and the savings rate of non-US major economies declines.

US trade outcome needs to be at the heart of any G20 discussions on 'how to save the world'

The 'best' scenario, shown together with the others in the table below, should be at the heart of anything that the G20 plan to do to 'save the world'.

Table 2: Possible US Trade Outcomes

	Bad scenario		Better scenario		Best scenario	
	Exports -8.4%	**Imports** -14.7%	**Exports** +12.0	**Imports** +7.4%	**Exports** +11.8%	**Imports** -0.12%
Monthly trade deficit (US$bn)	**-25.7**		**-36.8**		**-24.5**	
% of GDP	**-2.2**		**-3.1**		**-2.1**	

Source: US Census Bureau, GS Global ECS Research

3. O'Neill J. 'The Outlook for the Dollar in the Next Decade', *Global Economics Paper 180,* 2009.

G20 Issues and Possible Solutions

At their November 2008 meeting, the G20 leaders released a 47-bullet plan to save the world. The October communiqué is reprinted in Appendix 1. At the time, they stated that the April G20 meeting would review the progress made on the 47 objectives set out last autumn. We will leave readers to reach their own conclusions as to how successful they have been. Of course, the November meeting took place just after the US election, and President Obama had no direct involvement. Critical to the success of this meeting will be how the new US Administration – less than three months into office – offers its own view on many of the issues under discussion, as well as to how decisive and determined they intend to be.

Four broad themes for G20 discussion: macroeconomic policy, increased financial regulation, international governance and free trade

We present our views on all the issues in four broad buckets, the components of which are frequently inter-related:

- General macroeconomic policy.
- Bank reform and regulation of the financial markets.
- International economic governance.
- Maintaining the rules of fair, global competition.

The table below lists the different categories that we think are likely to feature on the G20's agenda. We have left out some issues, such as those surrounding the developing World and Third World debt. We do not intend to discuss them in this paper, other than indirectly through other topics – in particular, the financial architecture. Improving the system of global governance will raise the voice of the emerging world, which is something we argue will remain critical to a better balance of the world economy and the future of the emerging world. We do not discuss regulation of hedge funds or the issue of tax havens in any detail either.

A General Sobering Comment

Before we discuss the issues, it is important to point out the limits to what the G20 can achieve. Most monetary and fiscal policy issues are the domain of domestic policymakers, and even in the event of the G20 being the legitimate forum for global co-operation, in these and other areas, there is limited scope to achieve truly implementational cooperation. The same can also generally be said of banking policies, including regulatory matters. In reality, the choice of regulatory framework will depend on the choice of the elected (or otherwise) leaders of each country, and their perception of links to the social preference of their societies. Perhaps the two final buckets, the financial architecture and the rules of international competition, are areas where G20 co-operation is not only necessary, but critical – and most attainable.

Limits to what the G20 can achieve—most monetary and fiscal policy is the domain of domestic policymakers

Table 3: Issues for the G20

Economic	Banking	Financial Architecture	International Competition
1. Monetary policy	1. Transparency	1.Legitimacy of G6/G8	1. FX regimes and rates
2. Fiscal policy	2. Risk warning system to monitor market accounting	2. IMF reform	2. Industrial policies
3. Environmental economic policy	3. Credit agencies	3. IMF funding	3. Tariff and trade barriers
4. Imbalances	4. Regulators	4. IMF surveillance	4. Bank deleverage
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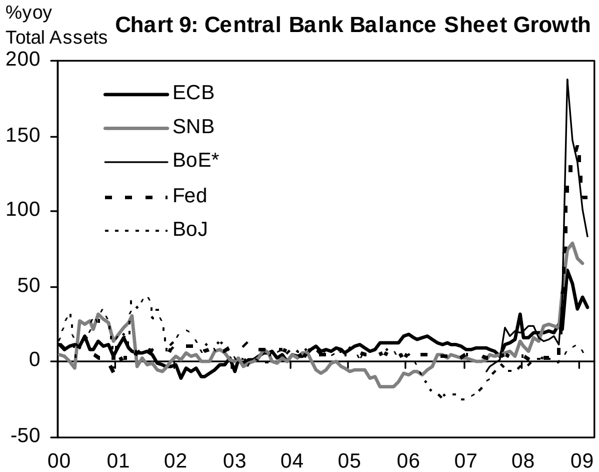
Source: GS Global ECS Research



*BoE began its current measure for total balance sheets assets in 2006
Source: Eurostat, National Banks

Macro Economic Issues

The main 'bucket' of economic issues essentially covers four sub-areas that are primarily related to macro policies: monetary policy, global imbalances, fiscal policy and, linked to the latter, environmental economic policy. Aspects of these economic policy issues have already been touched upon, and will be in other sections, but a separate comment about each is worth making here.

Independent central banks control monetary policy in most G20 nations

Monetary policy. In many ways, monetary policy is one of the least applicable areas for the G20 to opine, as in the majority of G20 countries monetary policy is under control of independent central banks. In theory, and indeed in practice before this crisis, governments were often best served by saying as little as possible about monetary policy. Nevertheless, this frequently does not deter many and, given the collapse of economic activity in the past few months, it has become difficult to avoid politicians offering their views. For example, on his brief visit to the US in March, G20 host UK Prime Minister Brown told the US Congress that he thought interest rates should be cut around the world. While this was one day ahead of a UK MPC meeting for the Bank of England – which cut rates 50bp – it is not clear who his remarks were aimed at, or who he thought he might influence. Nonetheless, many G20 leaders will probably be offering their views on monetary policy issues at the April meeting. While we have our own views on the likely next step for monetary policy around the globe, it is not, for the reasons already explained, a primary purpose of the G20 meeting. As we have already outlined[4], many major central banks are in any case now undertaking various forms of 'quantitative easing'. The easiest way to demonstrate the nature of this is to show the degree of balance sheet expansion, as illustrated in the chart above.

G20 leaders need to address global imbalances

The G20 leaders will likely encourage our major central banks to continue in this expansionary direction!

Global imbalances. This is one of the macro policy issues we have discussed already. As emphasised earlier, the global current account and broader, balance of payments situation is at the heart of the crisis that the G20 leaders are trying to address. So, this should be something that they talk about more, not least as trying to maintain a world economy with smaller balance of payments imbalances is one of the key areas where the G20 can co-ordinate. Unfortunately, the November G20 summit in Washington DC did not focus much on this issue, and the signs are not encouraging that they will do so to a greater extent in London. As I discuss later in the context of IMF reform, it is a

4. Berezin P. et al. 'Quantitative Easing: Coming Soon to a Central Bank Near You', *Global Economics Weekly 09/09*.

Prepared Statement by Treasury Secretary Tim Geithner in Advance of the G20 Finance Ministers and Central Bank Governors' Meeting

Washington, DC. This week, the G20 will meet in London amid a severe global economic downturn and ongoing stress in the world's financial markets. This is a global crisis which calls for a global response. The G20 Finance Ministers have two agenda items for that global response: how to ensure recovery and restart growth, and how to reform and coordinate the international regulatory and supervisory system to ensure that no such crisis occurs again.

The global recession is deepening. The International Monetary Fund (IMF) has estimated that the global economy is likely to contract by 0.5 percent in 2009. Unemployment is rising and world trade is likely to decline by at least 3 percent and probably more in 2009. Last week's jobs report showed that unemployment in the United States rose to 8.1 percent in February. In the fourth quarter of 2008 we saw the biggest quarterly decline in real US exports since 1971. Our economy needs a revival of global growth to complement the stimulus we are injecting at home. US exports, US jobs and the health of the US economy are inextricably linked to the health and stability of the global economy.

The G20 countries must take strong macroeconomic and financial sector measures. In the United States, we moved quickly to pass the American Recovery and Reinvestment Act, which lays a foundation for economic recovery through a powerful mix of investments and tax cuts to create jobs and strengthen our long-term growth potential. The G-20 countries have also put into place fiscal stimulus. We believe it is important for G20 nations to commit to substantial and sustained actions for a period that matches the likely duration of the crisis. The IMF has called for countries to put in place fiscal stimulus of 2 percent of aggregate GDP each year for 2009-2010. This is a reasonable benchmark to guide each of our individual efforts. We think the G20 should ask the IMF to report quarterly on countries' stimulus efforts scaled against the relative shortfall in growth rates.

Forceful financial sector actions are critical to rebuild confidence, restore market functioning, get credit flowing and bring stability to the global financial system. In the United States, we are implementing a series of aggressive initiatives to stabilize and strengthen our financial system to support economic recovery, and we look for complementary actions around the world.

It is important, as well, for each of us to reaffirm commitment to open trade and investment policies, which are essential to global economic growth and prosperity.

As the crisis has spread from advanced economies, emerging market and developing countries are experiencing a severe economic slowdown and sharp declines in capital inflows and exports. The G20 countries, working with the international financial institutions, should mobilize substantial resources that can be deployed quickly and in innovative ways to help emerging market economies and developing countries restore growth and begin recovery. To build on this effort, the G-20 should support substantially increasing emergency IMF resources through a significant expansion of the New Arrangements to Borrow (NAB). The NAB could be increased by up to $500 billion and membership could be enlarged to include more G-20 countries. We welcome the international effort to raise temporary resources for the IMF. In addition, we are prepared to explore additional actions to provide support for the poorest countries given the impact of the crisis and the need for global liquidity. The World Bank and other Multilateral Development Banks must more effectively leverage existing resources by flexible use of their balance sheets to help meet financing needs.

The additional resources should be targeted to help emerging market and developing countries restore growth, embark on recovery, and expand trade. In this context, the G-20 should come together to support the efforts of the World Bank and other institutions to coordinate trade financing initiatives. We support bringing together bilateral and multilateral institutions, including export credit agencies and multilateral development banks, to use their substantial resources to attack risk and liquidity barriers to the flow of trade finance.

Just as the G-20 countries must work together to restore growth, we must at the same time build a strong supervisory and financial regulatory framework for the future to ensure no such crisis occurs again. There has been a lot of talk about reform. Now is the time for action. The US will lead in this effort and prior to the April Summit will lay out critical elements of our regulatory reform program. The United States will promote a race to the top, not to the bottom.

The G20 should come together cooperatively to agree on a broad framework of reforms to raise standards globally:

We must ensure that all **systemically significant financial institutions that operate globally are subject to strong standards of supervision and regulation.**

cont'd Prepared Statement by Treasury Secretary Tim Geithner in Advance of G20 Finance Ministers and Central Bank Governors' Meeting

We should exercise effective oversight of markets critical to the functioning of the financial system, such as derivatives.

We need to put in place a stronger framework of capital requirements that provides better protection against future crises and ensures financial institutions can build up capital in good times and draw capital down as a buffer in bad times.

We must strengthen cooperation to fight money laundering and terrorist financing and to crack down on those who use offshore tax havens to escape paying their share of taxes.

We need to have a standing cooperative framework for actions in a crisis to provide better tools for crisis resolution that keep pace with the changes in the international financial system.

As part of this effort, we need to reform and strengthen the Financial Stability Forum (FSF) so that it can play a more effective role alongside the original Bretton Woods institutions in strengthening the financial system. This requires expanding the membership to include all G20 countries, giving it a stronger mandate for promoting more robust standards consistent with the principles above, and working with the IMF and World Bank to monitor the implementation of those standards.

Finally, the international community should comprehensively address substantial governance reforms of the international financial institutions. We should commit to a clear roadmap toward agreement on changes that would increase the voting shares and financial roles of the dynamic emerging market economies in the international financial institutions. To this end, the United States favors accelerating the conclusion of the next IMF quota review to January 2011 and aligning the World Bank process with that of the IMF.

March 11, 2009

stronger, more self-confident IMF that needs to opine on the outlook for global imbalances, their importance in the context of other policy challenges, and who should be responsible for what.

Fiscal policies. Given that governments are in charge of fiscal policy, this is an area that many see as a legitimate topic and action point. However, whether democratically elected or otherwise, again it is some form of parliament that decides, or certainly approves, fiscal policy changes. Even within the European countries that participate in EMU, where there is a common fiscal policy framework, actual changes in fiscal policy are driven by domestic parliaments.

G20 stance on fiscal policy is also highly relevant

Nonetheless, especially in the context of other economic issues, the absolute and relative stance on fiscal policies of the G20 members is highly relevant. If the monetary transmission mechanism is impaired in many countries, then fiscal policy may need to be more active than usual as a cyclical policy tool, and to help reduce the depth of recession. Indeed, given that interest rates are already so low and central banks are resorting to quantitative easing, fiscal expansion may also help the near-term goals of monetary policy. Secondly, in the context of global imbalances, and different savings and investment rates, while many G20 leaders talk of the need and desire for joint fiscal expansion, in reality, more carefully thought out and differentiated fiscal responses would be more sensible.

As can be seen in the box, US Treasury Secretary Tim Geithner has set the scene on this issue by calling for a collective fiscal stimulus of 2% of GDP.

In our view, generally speaking, those countries with the weakest savings rates should be moderately less aggressive in fiscal expansion, and those with higher savings rates should – from a global and their own perspective – be pursuing more expansive fiscal policies. Of course, the existing level of debt and other aspects of tax and spending policies linked to domestic constraints (or in the case of EMU, the Growth and Stability Pact) need to be considered.

Table 4: Fiscal Positions

	2009 Fiscal Thrust*	(% GDP)	2009 Deficit % of GDP	2009 Debt as a % of GDP
US	$787bn[1]	5.6%	-10.2%[2]	53.6%[3]
Japan	Y10.6trn	2.1%	-7.2%	170.8%
China	1.18trn RMB[4]	3.9%	-3.6%	n/a[5]
Canada	$18bn CAD	1.2%	0.0%	29.3%
UK	£22bn	1.5%	-8.9%	57.8%
EU	128.6bn EUR[6]	1.8%	-4.2%	73.3%
Germany	70bnEUR	2.0%	-3.7%	72.9%
France	33.5bnEUR	1.5%	-5.4%	70.8%

*Some of the fiscal thrust may be spent over several years.

1. $70bn of the $787bn figure is for the Alternative Minimum Tax fix, w hich w e do not consider to be true stimulus. $257bn is expected to be spent in 2009.

2. This figure includes TARP acquisitions at net present value per CBO accounting.

3. Debt held by the public, including the Federal Reserve, not including various trust funds (e.g. Social Security and Medicare). Does not include state and local debt.

4. RMB1.18 trillion w as recently announced as additional central government spending, and is estimated to lead to a total investment of around RMB4 trillion.

5. Data unavailable. The 2008 level w as approximately 20%.

6. Only includes announced packages in Germany, France, Italy and Spain.

Source: National Sources, GS Global ECS Research

In this context, many might recommend that the US (and UK) pursue relatively less expansionist fiscal policy, and that China, Germany and Japan – among the large countries – should pursue more expansionist policy. According to the Bruegel[5], the 2009 fiscal impulse in the EU will be around 0.9% of GDP, less than one half of the 2% estimated for the US. If you believe that global imbalances are part of the cause of the crisis, and that relative domestic demand is influenced by fiscal policy, then, if accurate, this relative fiscal stance is inappropriate. This is also a key area where the IMF should be more visible and its voice credible today and in the future, as Geithner argues.

So far, only China's fiscal policy looks appropriate

The table above shows our latest GS estimates of the thrust of fiscal policy, and the current level of fiscal debt, and deficits in the major economies and regions.

Ahead of the G20 Summit, perhaps only the thrust of China's fiscal policy seems to fit with the criteria laid out here.

Fiscal policy as it relates to environmental issues. Despite the general observation that fiscal policy is the domain of domestic economic policy, one could conceive of a special effort to implement a co-ordinated fiscal stimulus relates to environmental issues, alternative energies and energy efficiency. UK Prime Minister Brown suggested in advance of the meeting that the World Bank should be encouraged to take more responsibility for tackling the challenges of global warming, and specifically proposed 'an environmental bond' (in speeches made in London on February 10).

A co-ordinated fiscal stimulus related to environmental issues is needed

Given that US President Obama and many leaders in Europe and elsewhere share a belief in the need to undertake steps to improve the environment, why not use this crisis and the G20 Summit to introduce a special fiscal stimulus? Instead of just a World Bank bond issue, one could conceive of a special bond issue in all the member countries participating in the G20 meeting, whose proceeds could be used for specific government funding or measures to improve efficiency and boost alternative, cleaner energies. As part of this, or in addition, subsidies and tax incentives could be used to help stimulate the private sector's research and development in such areas. Some support for the auto industry could perhaps be justifiable through policies directed for automobiles using more energy efficient technologies. It is even conceivable

5. Pisani-Ferry J., "Where Europe Meets the G20", The London Summit 2009, Bruegel, March 2, 2009.

Our Thoughts on Mark-to-Market Accounting

As the challenges facing the financial sector have grown, the opposition from some quarters to fair value, or mark-to-market, accounting – a process that assigns current values to financial assets and liabilities – has increased. In the *Global Economics Weekly* of July 9, 2008 (“Fair Value Accounting and Economic Challenges”), Chief Accounting Officer Sarah Smith presented her views on why Goldman Sachs regards mark-to-market accounting as fairer and more sensible than the alternatives. Opponents of fair value accounting argue that as asset prices decline, the strict imposition of mark-to-market accounting accentuates the balance sheet problems of financial institutions. By reporting book losses associated with illiquid securities, banks are forced to reduce leverage to maintain their appropriate, and usually BIS-mandated, capital ratios, which in turn accelerates the vicious circle.

We see two major problems with this view. First, it is not very credible for financial institutions to argue that marking to market is inappropriate only during downturns. Second, if the underlying assets are worth more than institutions are being ‘forced’ to value them at, presumably there will be an increase in the number of value-driven buyers of these undervalued assets. Moreover, financial institutions will see mark-to-market gains when and if the assets appreciate.

As opposed to changing the fair value accounting rules, policymakers could choose to broaden their own lender of last resort activities; they could require financial institutions to raise more capital; or, in certain circumstances, it may be considered prudent to relax capital ratios. The US Federal Reserve Board’s March 2008 decision to extend temporarily its Discount Rate facility to non-bank primary dealers is a good example of the positive impact of intervention by policymakers.

that China, India and other big emitters of greenhouse gases could join in such a policy ‘initiative’. If our major nations are keen to demonstrate their belief in tackling global environmental challenges, what better way to show it? It would be an excellent way to set the stage for major agreements at the Copenhagen Summit on Climate Change in December 2009.

Banking Reform and Regulation of the Financial Markets

This is the bucket with the most topics, and judging by the November communiqué and words from many G20 leaders since, the April summit is highly likely to have more to say, and perhaps specifically to announce, on this broad topic. An interesting set of proposals for the G20 to implement were offered by the Issing Commission in February[6]. Many of them seem sensible.

G20 leaders will call for greater transparency in financial services

Transparency. One area that the November G20 communiqué highlighted was a call for greater transparency within the financial services industry. This may seem an obvious goal and, indeed, something that would be more desirable on a broad scale throughout business and government. One could also suggest the need for greater transparency from credit rating agencies (we discuss the issues about the ratings agencies below). In the context of global governance, this would seem to be especially apt also, given the G20 format, as we will discuss later.

They should also require more transparency from the credit rating agencies

Greater transparency is by definition, obvious and highly desirable for the financial services sector. What does this really mean? The issue is more complex than a simple request for more. Most of the underlying requests from banks are presumably for greater clarity about the size of their impaired or so-called ‘toxic assets’ and, probably, mark-to-market valuations. As evidenced by the continuous efforts by policymakers to help resolve the pressure on the banking system, it is not easy to do this, partly because under mark-to-market accounting, the valuations are constantly changing. Moreover, what makes this financial crisis so different from any in the past, are the immense difficulties involved in estimating the valuation of impaired derivative instruments (in some cases, the market for which has dried up). Nonetheless, the G20 will undoubtedly call for greater transparency.

6. Issing O. et al. ‘New Financial Order: Recommendations by the Issing Committee’, Issing Commision, Bundesregierung, 2009.

GS CEO Lloyd Blankfein on Mark-to-Market Accounting

In a recent op-ed piece in the *Financial Times* on February 8, 2009 ("Do not destroy the essential catalyst of risk"), our CEO Lloyd Blankfein made reference to his views on the subject. He disagreed with those who suggest that fair value accounting is one of the main factors exacerbating the credit crisis. "*If more institutions had properly valued their positions and commitments at the outset, they would have been in a much better position to reduce their exposures*". In fact, the daily marking of positions to current market prices by Goldman Sachs was a key factor to our decision to reduce risk early in markets and in instruments that were deteriorating. This process, albeit difficult, is a good discipline that should define financial institutions.

Given the size and interconnected nature of markets, managing operational risk will become even more important going forward. We should consider important principles for our industry, for policymakers and for regulators, based on the lessons derived from this financial crisis. Risk and control functions need to be completely independent from the business units. Moreover, risk managers should be given more independence as well as greater stature in decision making. "*For the industry, we cannot let our ability to innovate exceed our capacity to manage.*"

Mark-to-market accounting. Over the past months, a number of commentators have argued for the temporary halt to mark to market (or fair value) accounting, and some have suggested it should be abandoned altogether and have called for a return to accrual accounting, in order to help reduce the pressure on banks to raise more capital and, of course, to allow them to mark many assets at a higher valuation than currently. Some of the G20 members could conceivably call for an end to mark-to-market accounting but we doubt this will be agreed. Nor do we think it should be. We outlined our thoughts on this topic in a *Global Economics Weekly* last year[7] (see box on previous page), and our CEO Lloyd Blankfein[8] made reference to his views on the subject in an op-ed piece in the *Financial Times* on February 8, 2009 (see box above).

An end to mark-to-market accounting unlikely to be proposed

Credit rating agencies. As mentioned by the Issing Commission and Blankfein, the credit rating agencies appear to have played a role in the build-up to the crisis, by providing AAA ratings for securities that were not such high quality. Many professional investors might not rely on rating agencies. They may well use their own research, and regard market prices as a better 'rating' for a security, and somewhat speedier than the ratings agencies, but the same cannot be said for less experienced or retail investors, who do not have the expertise and rely on 'independent' advice. In this regard, the major ratings agencies appear to have made significant mistakes. In hindsight, maybe they have not been truly independent, given that the financial services industry is the source of their fees. As is likely to be proposed by the G20, a new structure for the independence of rating entities will be necessary

Regulatory bodies. It also seems possible that a number of regulatory bodies have failed in some aspects of the crisis. In most of the countries that have been badly affected, regulators failed to stop the systemic crisis from developing. The breadth of the crisis globally suggests that perhaps some stronger and more effective global regulatory body may be necessary, especially if we are to maintain private-sector financial institutions that undertake significant global business. How can we have large international financial institutions without corresponding international regulation? On March 14, the G20 Finance Ministers announced steps to boost the importance of the Financial Stability Forum (FSF) and its membership will broaden beyond the major developed countries. All G20 countries and Spain will now be members. The FSF will publish a report with specific recommendations for actions to improve the effectiveness of regulatory policies around the world. Whether this will be

Stronger and more effective regulatory bodies may be needed

7. Smith S. 'Fair Value Accounting and Economic Challenges', *Global Economics Weekly 08/26*.
8. Blankfein L. 'Do not destroy the essential catalyst of risk', *Financial Times*, February 8, 2009.

sufficient to prevent future financial crisis from transmitting across borders remains to be seen. Indeed, only when the next crisis appears will we be able to tell. In any case, the difficult reality is that some countries will not accept the standards of an international regulatory body because, in many cases, the specifics of regulation will reflect the social policies of nations. Will Germany and the US want to apply the same regulations to their banks? Will China? Will they be prepared to actually accept the laws of an international body? The fact is that our societies are different, and may want their banks to perform different functions. It is difficult to see how an international regulator can be truly persistently effective.

What does seem necessary, irrespective of the effectiveness of a stepped-up FSF, is that the regulatory bodies need to work harder to develop and maintain an informational advantage over their financial sectors. This is an issue for domestic policymakers.

Supervision of banks and financial institutions. The severity of this crisis has raised genuine questions about the business model of both universal banks and investment banks. As the crisis has advanced, and the cost of crisis management has shifted to sovereign risk, even the question of the size of banks has come to the forefront. Our views on these issues will be explained more in the forthcoming GS GMI paper mentioned earlier.

Bank compensation. The gravity of the crisis has brought the compensation structure of the banking industry under scrutiny. Both in the US and UK, government has placed a compensation cap on institutions that have required official government support. The forthcoming FSF report is very likely to make some recommendations about compensation in the banking industry.

We would like to make three key points in terms of what is appropriate compensation practice:

Bank compensation should be more closely tied to companies' long-term performance

- As is emerging in any case, bonus compensation should be more closely tied to the long-term performance of companies – whether financial or otherwise. A system of rewarding immediate apparent profit with cash bonuses is not appropriate. Linking compensation more specifically with long-term profitability is a must.

- As with the areas of corporate best practice, non-executive directors need to be allowed to play and be capable of playing a stronger role.

- However, it is important that policymakers and regulators do not place artificial ceilings on compensation. Forces of supply and demand for skilled labour need to be allowed to function in any industry. Artificial controls will be circumnavigated (as they were in the 1970s and 1980s through generous free car schemes, etc). If it is the case that financial services employees do not constitute 'skilled' labour, as is now widely perceived, then the demand for their services will wane.

But regulators should not impose artificial ceilings on compensation

Non-executive directors. It has become popular to bemoan the role played by many players in this crisis. This includes the role of non-executives. However, just as with apportioning the blame among bankers, credit rating agencies and policymakers, the same is true for non-executive Directors. Judgement needs to be objective. As Callum McCarthy, the former head of the UK FSA, is fond of saying, the non-executive board of Northern Rock included experienced investment managers and banking executives. This did not prevent Northern Rock from failing as a private business. Arguments that banks had inadequate non-executive boards are not really supported by the evidence. Whether such boards were well-enough informed or sufficiently independent from the executives are probably more valid issues, but the financial sector is not alone in this regard. Non-executive directors can perform better, but they are not alone.

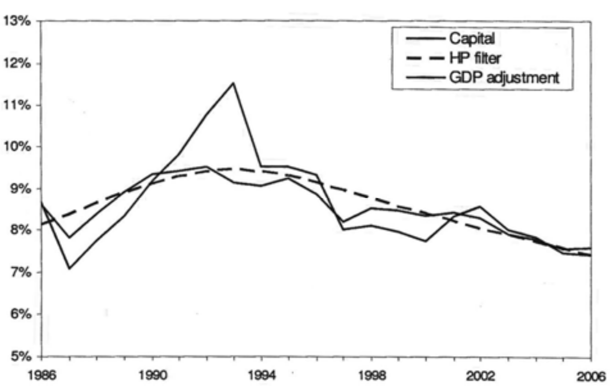
Bank capital and pro-cyclicality. One area where many seem to agree, and where the G20 is highly likely to agree is the dilemma of the pro-cyclicality of bank capital. In boom times, everything looks good, credit expands, asset prices rise. How often do you hear the phrase, 'this time it is different'? Well, it usually isn't, and eventually it becomes clear that the boom is inconsistent with fundamentals. In recession times, the opposite tends to occur. Everything seems bad, banks cut lending, making the macro environment and sometimes their own problems worse. 'This is never going to end' is another phrase we all often hear, although perhaps less than 'this time it is different'. To deal with this problem, the Issing Commission has recommended a series of steps. These include: better systematic monitoring of exposures; developing and maintaining a set of indicators (both macro- and microeconomic) to alert policymakers of rising systematic exposure; better regulatory co-operation internationally, including an increased role for the FSF; and, perhaps most controversially, a new general macro policy bias of 'leaning against the wind' using monetary and regulatory instruments. The latter recommendation is perhaps the least likely to be adopted as a specific policy tool, especially in the near term. The other recommendations are likely to be embraced and introduced in some form.

Better systematic monitoring required to address pro-cyclicality of bank capital

In the same vein, Repullo, Saurina and Trucharte[9] propose a simple guideline to combat pro-cyclicality. Using the experience of Spain, they recommend using a simple multiplier of the Basel II requirements that depends on the deviation of the rate of growth of GDP compared with its long-term average. Based on their results, they specifically recommend that the multiplier be increased in expansions (or decreased in recessions) by 7.2% for each one standard deviation in GDP growth, i.e., 7.2% more capital needs to be raised when GDP is 1% above trend, and vice versa. The chart shows how the cycle would be smoothed using this approach. There are some difficulties in applying such a simple metric to international banks, but its simplicity is attractive. While it might be difficult for an international regulator such as the FSF to enforce such a defined rule, it would be sensible for them to prescribe something along these lines.

Risk warning system. As has become clear in the discussion of a number of the issues above, there is a need to develop a better 'warning' system. The Issing Commission specifically suggests this with respect to both macro and micro indicators, and offers this advice to the FSF, domestic regulators and, implicitly, domestic central bank policymakers. For central banks, in essence

Chart 10: Smoothing the Basel II capital requirements with GDP growth



Source: R. Repullo, J. Saurina, and C. Trucharte (2009), "Mitigating the Procyclicality of Basel II", in M. Dewatripont, X. Freixas, and R. Portes, Macroeconomic Stability and Financial Regulation: Key Issues for the G20, CEPR, London.

9. Repullo R. et al. 'Mitigating the Procyclicality of Bessel II', CEMFI and CEPR, Bank of Spain, 2009.

they are recommending something akin to a 'second pillar' of monetary policy. In our judgement, this seems sensible and is consistent with our belief that some form of financial conditions are useful leading indicators. Perhaps Inflation Targeting of goods and services prices alone is not a sufficient goal. The Issing Commission has also recommended that the IMF 'chair' a risk-mapping project, of which financial indicators would constitute critical elements.

In addition, the Issing Commission recommends that the IMF should take the lead in devising a 'Global Stability Pact' for the conduct of fiscal policy.

IMF could take the lead on many global macroeconomic issues and 'chair' a risk-mapping project

While we doubt, especially in the current environment, that many countries would sign up to some version of a global Maastricht-like Treaty, it is highly appropriate – and sensible – for a more forceful and representative IMF to have a clearer and louder voice on many macroeconomic issues. As we discuss in the next section, improving the relevance and effectiveness of the IMF should be a major focus of the G20. The IMF should immediately having a more significant input on fiscal and monetary matters, global imbalances, cross-border capital flows and exchange rates, if it is to become more representative of the modern world economy.

Recapitalisation of the banking system. This final issue is arguably the single most important issue in this section for global financial markets as we approach – and leave – the April G20 meeting. How can we find enough capital to support our banking systems? G20 leaders will no doubt make suggestions, both individually and perhaps collectively, but the G20 meeting is unlikely to be able to solve this problem, for three reasons:

Domestic governments, rather than the G20, should work to solve the problem of recapitalising the banking system

- As discussed under the regulatory regime section, it is ultimately the preserve of domestic regulators and policymakers. While international agreement would be desirable, in reality is it realistic, and is this enforceable? Can we really expect all G20 countries to share the same belief about how much capital their banking system needs? And, indeed, should they?
- For cross-border purposes, some common capital requirements are necessary (this is why Basel II was developed) but to implement a similar and globally agreed bank recapitalisation plan is probably not feasible. After all, would US policymakers be prepared to fully implement and enforce a proposal such as suggested by Repullo, Saurina and Trucharte? Probably not.
- Despite this, it is necessary and urgent that, complementary to the G20 meeting, domestic governments continue with their plans to help recapitalise their domestic banking systems further.

International Governance and Architecture

Interwoven with many of the issues discussed already is the critical issue of governance of the world economy. In our opinion, this is both one of the most critical and realistic issues for the G20 to deal with. At the core lie many aspects of much of our writing on the rise of the BRIC economies. Indeed, our 2001 global paper[10], 'Building Better Global Economic BRICs' captures the essence of the issues. The IMF needs to be significantly reformed. It needs to become more powerful, independent and legitimate. And around a revamped IMF, we need a system of governance that reduces the importance of the ageing G7 nations (Europe, in particular) and increases the representation of China and other emerging nations. If this is agreed, then a large increase in funding for the IMF is likely to materialise.

The IMF needs to be significantly reformed

10. O'Neill J. 'Building Better Global Economic BRICs', *Global Economics Paper 66*, 2001.

Reform of the 'Gs'

In terms of systematic global monetary matters, the G7 should become a G4, consisting of China, the EU, Japan the US. Those four regions are big enough to exert a systematic influence on the world economy, and its exchange rates and capital flows. To supplement the G4, we need to see an expanded G8 (G7 plus Russia) evolve into a G14. In addition to the other three BRIC economies, China, Brazil and India, Mexico (which could be considered a potential BRIC), Saudi Arabia and South Africa should participate in a regular, perhaps quarterly, meeting of key policymakers. Supplementing the efforts of the G4, these nations could be the legitimate body to deal with other critical issues of today and the future, including those pertaining to energy, climate change, the poorest nations and their net debt challenges, and much more.

Table A: List of Countries

G7	G8	G10	G20*
US	US	US	US
Japan	Japan	Japan	Japan
UK	UK	UK	UK
Germany	Germany	Germany	Germany
France	France	France	France
Italy	Italy	Italy	Italy
Canada	Canada	Canada	Canada
	Russia	Belgium	European Union
		Netherlands	Brazil
		Sweden	Russia
		Switzerland	India
			China
			Argentina
			Australia
			Indonesia
			Mexico
			Saudi Arabia
			South Africa
			South Korea
			Turkey

*Spain and Netherlands appear to be included also.

Is the G20 itself not the ideal body? In many ways, proposing yet another body after the arrival of the G20 may seem somewhat strange. The G20, created in the aftermath of the 1997 Asian Crisis, appears to have now replaced the G7/G8 forum as the modern 'legitimate' body. This is very welcome, and is substantially superior to the G7/G8. Indeed, in some ways, if the success of the G20 were to be to formally confine G7 meetings to history, then this in itself would be an achievement. Recent meetings, where the four BRIC countries plus South Africa have been invited along for "coffee" (as famously summarised by the Brazilian Finance Minster), are rather inappropriate. You cannot hope to achieve progress on many truly global economic and social issues unless those countries are granted a similar standing to those of the (declining) G7 nations. Hence, we see the G20 as preferable by far.

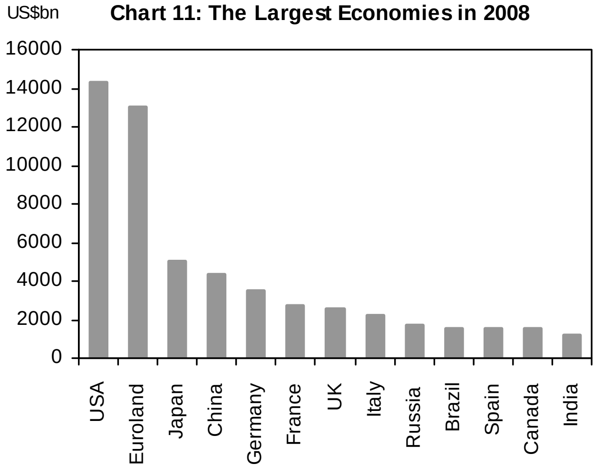
The G20 does, however, pose two major problems:

- It is too big to be effective – an argument offered, rather amusingly, as a defence of the G7 by some (usually Europeans). Replacing the G7 with a G20 would mean regular finance meetings may encounter difficulty in just finding suitable room space, given the frequent participation of Finance Ministers, Central Bank Governors and IMF officials).
- A better representation and governance of the IMF will not be achievable unless EU participants consolidate their presence in those fora formally. Consolidation of EMU participation and probably of others (especially the UK) makes practical sense. What is needed is for one country to be brave enough to give something up first in order that others may follow.

IMF legitimacy and the 'Gs'. The chart at the top of the next page shows the current size of the major nations. China has already overtaken Germany to be the third-largest nation in the world in terms of GDP, and is poised to challenge Japan. The other BRICs nations, Brazil, India and Russia, all of a similar size, are likely to approach the size of Canada and Italy in coming years. Within the EU, Germany, France and Italy have now spent 10 years sharing the same currency, resulting in a common monetary policy and a general framework for fiscal policy. We have written on those issues for many years, but in the current time of severe global crisis (see the box above), it is surely time to make world bodies more representative. If we can't take these, basic legitimate steps now, then what chance does the world economy really have of getting better help from policy?

We are not alone in writing on these issues. Virtually anybody who publishes on the topic shares much common ground. In the November communiqué, the G20 stated that there should be an overhaul of the global governance structure.

Chart 11: The Largest Economies in 2008



Source: GS Global ECS Research

Nothing specifically has happened since. Let's hope this is because the meeting took place around the time of the US elections. The official document published by the UK hosts[11] also includes improved governance of the IMF, and general international governance as one of its key objectives.

Should China and other large emerging nations have an increased weight in IMF voting?

Two other recent reports offer good specific ideas that could be implemented. In addition to other areas, the Issing Commission has many excellent actionable thoughts on governance. Truman – who joined the US Treasury on a short assignment in early March – has written a detailed report[12] on the IMF issues.

Lauren Phillips[13] from the LSE has proposed a simple, practical and bold step for the UK to offer its seat at the IMF for negotiation. In her proposal, by doing so, the UK could cajole the rest of Europe into moving, possibly pressurising the US to give up its bloc voting majority at the IMF, and leaving room for the Chinese and other larger emerging nations to increase their weight. Among other things, this would probably smooth the path for increased IMF funding, which we shall discuss below.

The Issing Commission has proposed a reform of the IMF, the Bank for International Settlements (BIS) and the FSF simultaneously. This makes sense. Specifically, for the BIS it proposes a further adjustment of quotas in favour of the largest Emerging Market countries, and that, in this context, the representation on the Board should be expanded beyond the G10 countries, to include China, India and Brazil. The de Larosiere report[14] carried complementary proposals, specifically suggesting that the EU should consolidate its IMF seats into just two.

Is there a need to alter the perception that the IMF is a tool of the US and Western Europe?

In January, Truman[15] proposed a detailed reform of the IMF (and World Bank). To improve its legitimacy, Truman identified the need to change the perception that the IMF is a tool of the US and Western Europe. Specifically he suggests:

- Management and leadership should be selected on the basis of qualifications regardless of nationality. (This has now been recommended formally from within the G20 by South African Finance Minister Trevor Manuel.)

11. Darling A. 'UK Objectives For the G20 in 2009', HM Treasury, UK, January 7, 2009.
12. Truman E. 'The G20 and international financial institution reform: unfinished IMF Reform', Op-ed in VoxEU.org, January 28, 2009.
13. Phillips L. "Spotlight on the G20 Working Groups: A New Impetus for IMF and FSF Reform", Critical Issues for the G20 Summit, Chatham House-Atlantic Working Group, March 5, 2009.
14. de Larosiere J. 'The High-Level Group on Financial Supervision in the EU', Brussels. http://ec.europa.eu/internal_market/finances/docs/ de_larosiere_report_en.pdf, February 25, 2009.
15. Truman E.M. 'The IMF and the Global Crisis: Role and Reform', Peterson Institute for International Economics, January, 2009.

Table 5: The IMF and the Global Financial Architecture

Category	End of 2009	End of 2010
Legitimacy	Reform management Selection	Double majority on management selection
	Further revise "new" quota formula	Reduce 85% majorities to 80%
		Reduce Europe's seats to 2-4 and board to less than 20 seats
		Revamp role of Executive Board
		Replace IMFC with Council[1]
Resources	Double quotas[2]	Establish presumption quota
	GAB/NAB[3]	Presumption of annual SDR allocations
	Borrow $50bn in Market	Approve 4th Amendment[4]
	Issue immediately $250 billion SDR[5]	
Relevance	Revisit SLF terms	Amendment to swap SDR for national currencies for SLF financing
	Expand the CFF	Reconsider capital account amendment
	Revise lending criteria[6]	Expand surveillance role: global imbalances exchange rate policies stability of financial sytems8
	Outline and monitor Fiscal programs	
	Monitor spillovers of Financial rescues[7]	Macroprudential policies[9]
	Vigorous Exchange Rate surveillance	

[1] This is a cosmetic move, but some countries want it and it does little harm

[2] On basis of further revised quota formula. Could be pre-financed using the "tin cup" approach.

[3] Consider expanding membership

[4] Should be a US commitment in London

[5] SDR 167 billion.

[6] Expand from BoP test to cover counter-cyclical fiscal deficits and international support for domestic financial institutions

[7] Jointly with FSF/BIS

[8] National systems

[9] Jointly with FSF; requires greater consensus on a macro-prudential analytical framework

Source: Truman, "The IMF and the Global Financial Architecture", March 2009

- A doubling of the majority of required member votes needed to elect leadership.
- That the G20 endorse an amendment of the IMF articles to reduce from 85% to 80% the voting majority needed to approve certain decisions.
- That Europe should reduce its IMF seats from between seven and ten to two, as others have suggested.
- The executive board should be removed from day-to-day management to a role of broad oversight.

Truman's recommendations follow from a more detailed working paper by the Peterson Institute for International Economics (PIIE), published in December. In this paper, Truman discusses the history of the IMF, its current status, including ownership and management, and its funding dilemmas, all in the context of the current global crisis. In the concluding sections, entitled "On what terms is the IMF worth Funding?", Truman concludes that the surveillance role should be significantly enhanced, and that, together with the FSF, they should undertake a number of enhanced surveillance responsibilities.

By March 2, at a conference in London hosted by the UK Treasury and Bruegel, and as a reflection of the deepening crisis, Truman had expanded his proposals significantly. In addition to proposing a bigger increase in the IMF's funding, Truman laid out detailed proposals for boosting the legitimacy and relevance of the IMF. His proposals are summarised in the table on the previous page.

Proposals outlined by US Treasury Secretary Tim Geithner on March 11 appear to be closely linked to Truman's ideas (see earlier box). They differed in one specific key aspect, as Geithner proposed a $500bn increase in the New Arrangement to Borrow (NAB), an amount at the higher end of many proposals.

Towards the end of his statement, Geithner also supported plans to reform and strengthen the FSF. He also proposed that the international community should address substantial governance reforms of the international financial institutions. Specifically, he suggested the need for a clear roadmap towards agreement on increasing the voting shares and roles of the 'dynamic emerging market economies' in the international financial institutions. Geithner summed up his statement by saying 'to this end, the United States favours accelerating the conclusion of the next IMF quota review to January 2011, and aligning the World Bank process with that of the IMF'. This was adopted by the G20 Finance Ministers on March 14 (see Appendix).

IMF purpose and surveillance. We have a very similar view to Truman on many aspects of IMF reform, including its governance and legitimacy. If these changes can be agreed and implemented, then it should be relatively straightforward to establish a clear purpose for the IMF, and increase its surveillance role in the world economy.

Similar to proposals made by Truman and the Issing Commission, South African Finance Minister Manuel proposed on March 12 that the IMF have a new executive body, which would replace the complex leadership of civil servants that is currently at the core of the IMF's structure. Better leadership is key to any organisation, especially one with a global purpose, and we strongly endorse Manuel's proposal. Assuming this can be agreed, in terms of surveillance, the IMF would have a much stronger, public voice in three areas of macroeconomics:

IMF does need to have a stronger public voice on global imbalances, exchange rate policies, and monetary and fiscal policies

- As we discussed in the opening section of this paper, there is a strong argument to suggest that the rapid increase in global imbalances lay at the heart of today's crisis. The IMF must develop a stronger voice on these critical variables that link the world economy.

- Similarly, and despite the complexities involved, the IMF must feel more confident (and be allowed) to publish its estimate equilibrium exchange rates, and offer an opinion on exchange rate policies. There are legitimate problems of uncertainty about such equilibria, a national reluctance to accept the implication of misalignment and fears that strong IMF pronouncement could encourage speculative investors to front-run policy changes, but none of these problems are sufficient to stop a more optimal balance of global exchange rates (discussed further below).

- The IMF, as proposed on March 11 by Geithner, should be more forceful in its assessment of monetary and fiscal policies in the major economies, especially where it disagrees with those of the largest economies. As is often felt in the emerging world (and the heart of why the IMF needs to be truly globally representative), the IMF can no longer be seen as too sensitive to the US and European interests.

In addition to those macroeconomic areas, as proposed by Truman, Issing and others, the IMF needs to develop together with the FSF a system of financial indicators, including those that relate to the banking system, but also portfolio flows in bonds and equities, and foreign direct investment. Such data could be presented in a format where evidence of unsustainable trends would be clear for all to see, allowing others, especially the FSF, to suggest measures to correct such flows before severe consequences set in. Mervyn King proposed similar ideas on a visit to India in 2006[16].

A brief note on the World Bank and WTO. Most of the pre-G20 attention has been focused on the need for a reform of the IMF, which is justifiable in view of its key role in macroeconomic stability policy, and this crisis. However, the need for a reform of the purpose and effectiveness of the World Bank and WTO are just as important, and evident. We share the desire of US Treasury Secretary Geithner that the reform of the World Bank should be aligned to that of the IMF. In addition, and consistent with UK Prime Minister Brown's proposal, the World Bank can clearly play a vastly enhanced role in global environmental policy issues, especially in the emerging world.

G20 should also focus on a reform of the World Bank and WTO

As for the WTO, the G20 meeting will inevitably commit to another statement opposing protectionist economic policies. In this regard, they will probably make a fresh call to try to pass the 'Doha Round' of the WTO. Perhaps there is a need to reform the WTO process itself? It often seems that just as the IMF has struggled to cope with the different nature and make-up of the modern global economy, so has the WTO. The G20 meetings are unlikely to focus on this.

International Competition

Four areas fall under the general subheading of international competition, all of which relate to topics already discussed. They are worthy of discussion in their own right, though, as they relate to the G20 meeting.

Exchange rates and FX regimes. Foreign exchange rates are unlikely to be an important specific focus of the April summit. However, as we have already discussed, global imbalances are possibly at the heart of the crisis. Exchange rate issues are closely linked to international balance of payments imbalances. The IMF needs to adopt a much stronger, credible voice on equilibrium exchange rates and FX policies**.**

Exchange rate issues closely linked to world's balance of payments imbalances

Lurking behind those issues, and heavily prominent in recent G7 Finance Minister meetings, is the sensitive question of the Chinese exchange rate and, in particular, the nominal exchange rate of the CNY against the Dollar and other major currencies. Closely linked to this, the US Congress is heavily focused on trade issues related to China and the exchange rate. As already discussed, it is imperative that the IMF is vocal about the equilibrium exchange

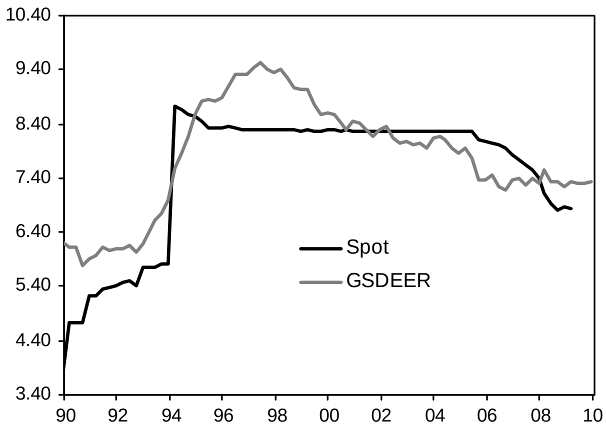
Table 6: GSDEER Estimates for Major Currencies

	Spot	GSDEER	
	19-Mar-09	End 2008	End 2009
EUR/$	1.37	1.17	1.17
$/JPY	94.51	116.31	115.90
EUR/JPY	129.12	135.62	135.83
£/$	1.45	1.56	1.57
EUR/GBP	0.94	0.75	0.75
$/CAD	1.24	1.15	1.14
$/CNY	6.83	7.25	7.34

Source: GS Global ECS Research

16. King M. 'Reform of the International Monetary Fund', Speech at the Indian Council for Research on International Economic Relations (ICRIER) in New Delhi, India. February 20, 2006.

Chart 12: $/CNY



Source: Global ECS

rate of the CNY, and other major currencies, and the implied nominal exchange rates. The table on the previous page has our GS estimates of equilibrium exchange rates, as depicted by our GS DEER estimates.

IMF must speak out on the equilibrium exchange rate of the CNY

We do not know what the IMF estimates of these exchange rates are. It is increasingly difficult to know 'why not'? The IMF has published frequently on exchange rate issues, including the dilemmas of the CNY rate, but we do not know the 'official' view. Our own GSDEER estimate for $/CNY implies that the CNY is no longer undervalued. We are not entirely confident about the accuracy of our estimate, not least as it appears to differ from others. However, the CNY has moved significantly since it was first allowed to appreciate in 2005. In addition, as discussed earlier, global imbalances are currently narrowing significantly.

The IMF has an obligation to publish its own views, especially given concerns about protectionist trade policies in the US and Europe.

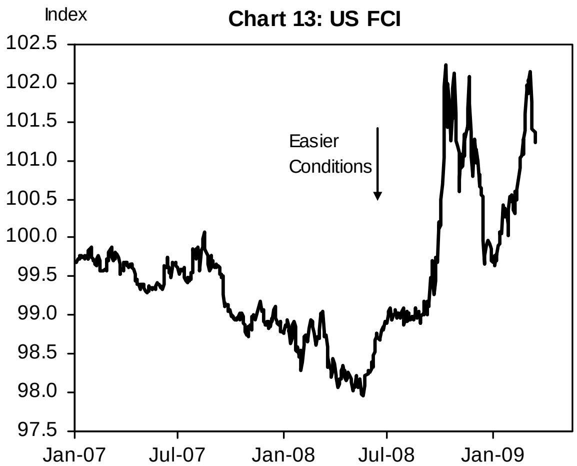
To add to the topicality of the importance of exchange rate issues in the run-up to the G20 meeting, on Thursday March 12, the Swiss National Bank announced, along with some other policies, plans to intervene in the foreign exchange market to halt the appreciation of the Swiss Franc, especially against the Euro. On the back of this announcement, the Franc fell sharply. The EUR/CHF rose from 1.477 from 5pm in London on March 11 to 1.532 by Friday March 13, a move of 3.8%, a huge move for the Franc.

We think the SNB has legitimate grounds for such policies, given that their nominal interest rate is close to zero, the Swiss economy is very open to international trade, and Swiss financial conditions have tightened considerably, largely because of the exchange rate. In this regard, we do not think the Swiss move should be regarded as a 'protectionist' step, as some are suggesting.

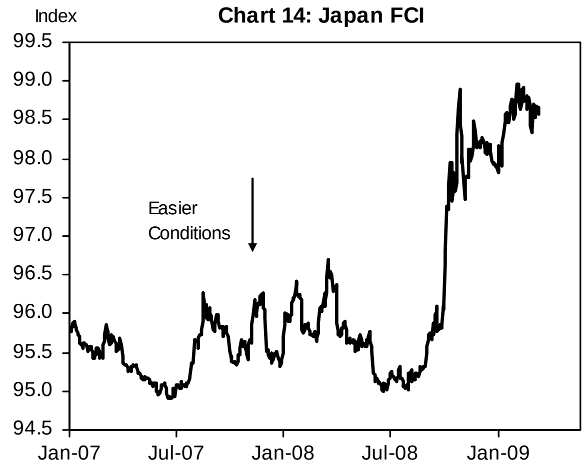
However, some key issues do arise for other countries as a result of the Swiss policy move, as markets have unsurprisingly immediately focused on. Given the large earlier declines in some currencies, especially the British Pound and perhaps the Swedish Krona, a number of countries whose financial conditions have tightened significantly may also have a legitimate case for desiring some weakening of their currencies.

The charts above, showing the financial conditions indices (FCIs) for four countries, suggest that Singapore, Japan and to some degree the Euro-zone and the US could all have such a view. Of course, and at the heart of the concerns about protectionism, the Yen, Euro and Dollar cannot be weakened simultaneously, and efforts by any of them to do so – without clear evidence of overvaluation – should be opposed. This is another matter for the IMF to speak out on.

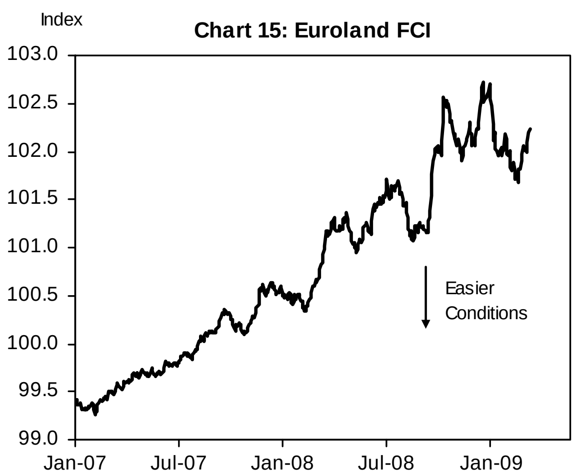
FCIs Have Tightened Since 2007



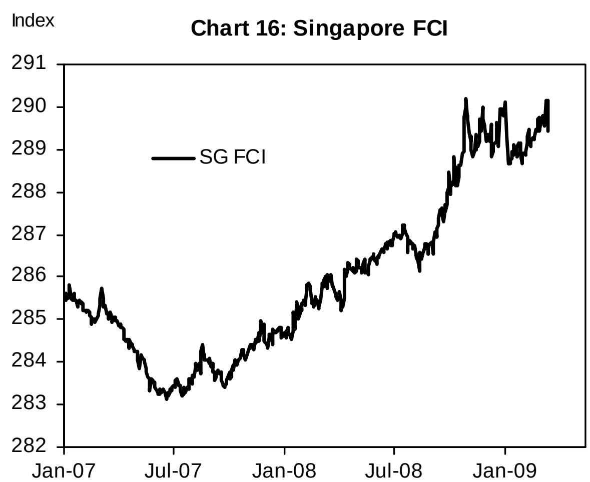
Source: Global ECS



Source: Global ECS



Source: Global ECS

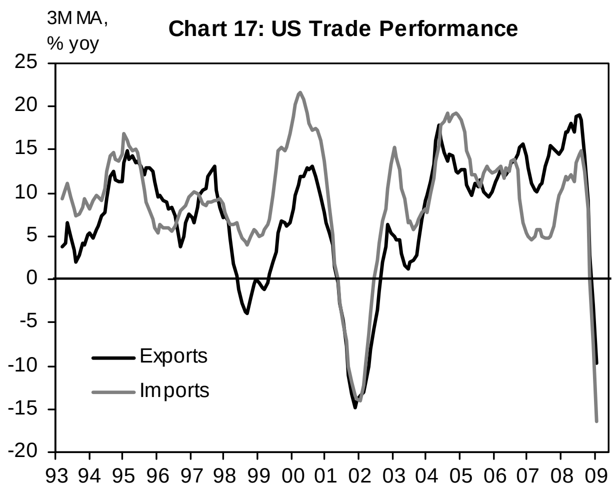


Source: Global ECS

Industrial policies. In an interview with the *Financial Times* on March 13, South African Finance Minister Trevor Manuel said that the reform of the IMF was an essential part of the battle to stem a drift towards nationalism and protectionism. As he also mentioned, at their November meeting in Washington, the G20 took a strong stance against nationalism and protectionism. He added that "this hasn't happened". According to Manuel, "Some of the participants have called for companies to pull out of Eastern Europe to support the situation at home". This probably refers to proposals by French PM Sarkozy that his government would provide financial support to auto companies so long as they showed a preference for factories in France rather than Eastern Europe.

France has not been alone with such a policy bias. Controversially linked to his fiscal stimulus, US President Obama included a 'buy America' policy. Also, some developing countries have signalled plans to consider import tariffs and quotas, Mexico being the latest example. Such moves are not desirable and are likely to aggravate the impact of the current savage slowdown in world trade. Trade data from the US recently epitomise the sharp collapse in global trade since October. Poor industrial policies designed to support key industries artificially are not justifiable.

Chart 17: US Trade Performance



Source: CENSUS

We believe the G20 should be more specific than in it was November to halt this growing problem. It should state clearly that actions aimed at supporting certain industries should be avoided and that G20 leaders should agree to oppose such actions. They might acknowledge two exceptions: first, in banking, where measures to support recapitalisation are necessary, as discussed earlier, and second, specific subsidies and other forms of support to industries that are adopting new practises and technologies. We would like to think that the G20 will adhere to this message, but we are not overly optimistic.

G20 has to be firmer in its opposition to protectionist policies

Bank deleveraging and domestic banking. A number of G20 ministers are focused on the dilemma that many banks with international operations are cutting their foreign bank exposures and lending more aggressively than in the domestic sphere. Some policymakers have implied that this is a form of protectionism. According to the latest BIS quarterly report, the outstanding stock of BIS reporting banks' foreign claims (on an immediate borrower basis) vis-à-vis all emerging regions declined significantly during the quarter, by $286 billion, although this number is probably exaggerated by the depreciation of emerging market currencies. While there are differences across borrower regions, the data suggest that, in real terms, banks' local claims in local currencies remained relatively stable, while their international claims declined. Those financial centres that specialise in international banking in particular are highly likely to be at the forefront of this threat, and their policymakers the most vocal on the issue. For instance, British Prime Minister Gordon Brown has talked about this topic in the past few weeks.

It is not clear that much can be agreed by the G20 on this reality. In circumstances in which many taxpayers have been forced to help recapitalise their banking systems and support domestic banks in other ways, it may be unrealistic to expect those banks to maintain the degree of their lending role overseas as lending slows at home. There is little that the G20 Summit can, or probably should, do about this. While the domestication of lending is a particular challenge for those nations that have allowed their banks to be owned primarily by foreign financial institutions, it is unclear whether the G20 can undertake special policies to help.

As has been the tone and purpose of this paper, if the G20 concentrate on what they can and should be able to achieve, then the outlook for the world, including the most exposed countries, will look better as a result.

Jim O'Neill

Appendix 1

DECLARATION

SUMMIT ON FINANCIAL MARKETS AND THE WORLD ECONOMY

November 15, 2008

1. We, the Leaders of the Group of Twenty, held an initial meeting in Washington on November 15, 2008, amid serious challenges to the world economy and financial markets. We are determined to enhance our cooperation and work together to restore global growth and achieve needed reforms in the world's financial systems.

2. Over the past months our countries have taken urgent and exceptional measures to support the global economy and stabilize financial markets. These efforts must continue. At the same time, we must lay the foundation for reform to help to ensure that a global crisis, such as this one, does not happen again. Our work will be guided by a shared belief that market principles, open trade and investment regimes, and effectively regulated financial markets foster the dynamism, innovation, and entrepreneurship that are essential for economic growth, employment, and poverty reduction.

<u>Root Causes of the Current Crisis</u>

3. During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system. Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions.

4. Major underlying factors to the current situation were, among others, inconsistent and insufficiently coordinated macroeconomic policies, inadequate structural reforms, which led to unsustainable global macroeconomic outcomes. These developments, together, contributed to excesses and ultimately resulted in severe market disruption.

<u>Actions Taken and to Be Taken</u>

5. We have taken strong and significant actions to date to stimulate our economies, provide liquidity, strengthen the capital of financial institutions, protect savings and deposits, address regulatory deficiencies, unfreeze credit markets, and are working to ensure that international financial institutions (IFIs) can provide critical support for the global economy.

6. But more needs to be done to stabilize financial markets and support economic growth. Economic momentum is slowing substantially in major economies and the global outlook has weakened. Many emerging market economies, which helped sustain the world economy this decade, are still experiencing good growth but increasingly are being adversely impacted by the worldwide slowdown.

7. Against this background of deteriorating economic conditions worldwide, we agreed that a broader policy response is needed, based on closer macroeconomic cooperation, to restore growth, avoid negative spillovers and support emerging market economies and developing countries. As immediate steps to achieve these objectives, as well as to address longer-term challenges, we will:

- Continue our vigorous efforts and take whatever further actions are necessary to stabilize the financial system.
- Recognize the importance of monetary policy support, as deemed appropriate to domestic conditions.
- Use fiscal measures to stimulate domestic demand to rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability.
- Help emerging and developing economies gain access to finance in current difficult financial conditions, including through liquidity facilities and program support. We stress the International Monetary Fund's (IMF) important role in crisis response, welcome its new short-term liquidity facility, and urge the ongoing review of its instruments and facilities to ensure flexibility.

- Encourage the World Bank and other multilateral development banks (MDBs) to use their full capacity in support of their development agenda, and we welcome the recent introduction of new facilities by the World Bank in the areas of infrastructure and trade finance.

- Ensure that the IMF, World Bank and other MDBs have sufficient resources to continue playing their role in overcoming the crisis.

Common Principles for Reform of Financial Markets

8. In addition to the actions taken above, we will implement reforms that will strengthen financial markets and regulatory regimes so as to avoid future crises. Regulation is first and foremost the responsibility of national regulators who constitute the first line of defense against market instability. However, our financial markets are global in scope, therefore, intensified international cooperation among regulators and strengthening of international standards, where necessary, and their consistent implementation is necessary to protect against adverse cross-border, regional and global developments affecting international financial stability. Regulators must ensure that their actions support market discipline, avoid potentially adverse impacts on other countries, including regulatory arbitrage, and support competition, dynamism and innovation in the marketplace. Financial institutions must also bear their responsibility for the turmoil and should do their part to overcome it including by recognizing losses, improving disclosure and strengthening their governance and risk management practices.

9. We commit to implementing policies consistent with the following common principles for reform.

- **Strengthening Transparency and Accountability:** We will strengthen financial market transparency, including by enhancing required disclosure on complex financial products and ensuring complete and accurate disclosure by firms of their financial conditions. Incentives should be aligned to avoid excessive risk-taking.

- **Enhancing Sound Regulation:** We pledge to strengthen our regulatory regimes, prudential oversight, and risk management, and ensure that all financial markets, products and participants are regulated or subject to oversight, as appropriate to their circumstances. We will exercise strong oversight over credit rating agencies, consistent with the agreed and strengthened international code of conduct. We will also make regulatory regimes more effective over the economic cycle, while ensuring that regulation is efficient, does not stifle innovation, and encourages expanded trade in financial products and services. We commit to transparent assessments of our national regulatory systems.

- **Promoting Integrity in Financial Markets:** We commit to protect the integrity of the world's financial markets by bolstering investor and consumer protection, avoiding conflicts of interest, preventing illegal market manipulation, fraudulent activities and abuse, and protecting against illicit finance risks arising from non-cooperative jurisdictions. We will also promote information sharing, including with respect to jurisdictions that have yet to commit to international standards with respect to bank secrecy and transparency.

- **Reinforcing International Cooperation:** We call upon our national and regional regulators to formulate their regulations and other measures in a consistent manner. Regulators should enhance their coordination and cooperation across all segments of financial markets, including with respect to cross-border capital flows. Regulators and other relevant authorities as a matter of priority should strengthen cooperation on crisis prevention, management, and resolution.

- **Reforming International Financial Institutions:** We are committed to advancing the reform of the Bretton Woods Institutions so that they can more adequately reflect changing economic weights in the world economy in order to increase their legitimacy and effectiveness. In this respect, emerging and developing economies, including the poorest countries, should have greater voice and representation. The Financial Stability Forum (FSF) must expand urgently to a broader membership of emerging economies, and other major standard setting bodies should promptly review their membership. The IMF, in collaboration with the expanded FSF and other bodies, should work to better identify vulnerabilities, anticipate potential stresses, and act swiftly to play a key role in crisis response.

Tasking of Ministers and Experts

10. We are committed to taking rapid action to implement these principles. We instruct our Finance Ministers, as coordinated by their 2009 G-20 leadership (Brazil, UK, Republic of Korea), to initiate processes and a timeline to do so. An initial list of specific measures is set forth in the attached Action Plan, including high priority actions to be completed prior to March 31, 2009.

In consultation with other economies and existing bodies, drawing upon the recommendations of such eminent independent experts as they may appoint, we request our Finance Ministers to formulate additional recommendations, including in the following specific areas:

- Mitigating against pro-cyclicality in regulatory policy;
- Reviewing and aligning global accounting standards, particularly for complex securities in times of stress;
- Strengthening the resilience and transparency of credit derivatives markets and reducing their systemic risks, including by improving the infrastructure of over-the-counter markets;
- Reviewing compensation practices as they relate to incentives for risk taking and innovation;
- Reviewing the mandates, governance, and resource requirements of the IFIs; and
- Defining the scope of systemically important institutions and determining their appropriate regulation or oversight.

11. In view of the role of the G-20 in financial systems reform, we will meet again by April 30, 2009, to review the implementation of the principles and decisions agreed today.

Commitment to an Open Global Economy

12. We recognize that these reforms will only be successful if grounded in a commitment to free market principles, including the rule of law, respect for private property, open trade and investment, competitive markets, and efficient, effectively regulated financial systems. These principles are essential to economic growth and prosperity and have lifted millions out of poverty, and have significantly raised the global standard of living. Recognizing the necessity to improve financial sector regulation, we must avoid over-regulation that would hamper economic growth and exacerbate the contraction of capital flows, including to developing countries.

13. We underscore the critical importance of rejecting protectionism and not turning inward in times of financial uncertainty. In this regard, within the next 12 months, we will refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing World Trade Organization (WTO) inconsistent measures to stimulate exports. Further, we shall strive to reach agreement this year on modalities that leads to a successful conclusion to the WTO's Doha Development Agenda with an ambitious and balanced outcome. We instruct our Trade Ministers to achieve this objective and stand ready to assist directly, as necessary. We also agree that our countries have the largest stake in the global trading system and therefore each must make the positive contributions necessary to achieve such an outcome.

14. We are mindful of the impact of the current crisis on developing countries, particularly the most vulnerable. We reaffirm the importance of the Millennium Development Goals, the development assistance commitments we have made, and urge both developed and emerging economies to undertake commitments consistent with their capacities and roles in the global economy. In this regard, we reaffirm the development principles agreed at the 2002 United Nations Conference on Financing for Development in Monterrey, Mexico, which emphasized country ownership and mobilizing all sources of financing for development.

15. We remain committed to addressing other critical challenges such as energy security and climate change, food security, the rule of law, and the fight against terrorism, poverty and disease.

16. As we move forward, we are confident that through continued partnership, cooperation, and multilateralism, we will overcome the challenges before us and restore stability and prosperity to the world economy.

Action Plan to Implement Principles for Reform

This Action Plan sets forth a comprehensive work plan to implement the five agreed principles for reform. Our finance ministers will work to ensure that the taskings set forth in this Action Plan are fully and vigorously implemented. They are responsible for the development and implementation of these recommendations drawing on the ongoing work of relevant bodies, including the International Monetary Fund (IMF), an expanded Financial Stability Forum (FSF), and standard setting bodies.

Strengthening Transparency and Accountability

Immediate Actions by March 31, 2009

- The key global accounting standards bodies should work to enhance guidance for valuation of securities, also taking into account the valuation of complex, illiquid products, especially during times of stress.
- Accounting standard setters should significantly advance their work to address weaknesses in accounting and disclosure standards for off-balance sheet vehicles.
- Regulators and accounting standard setters should enhance the required disclosure of complex financial instruments by firms to market participants.
- With a view toward promoting financial stability, the governance of the international accounting standard setting body should be further enhanced, including by undertaking a review of its membership, in particular in order to ensure transparency, accountability, and an appropriate relationship between this independent body and the relevant authorities.
- Private sector bodies that have already developed best practices for private pools of capital and/or hedge funds should bring forward proposals for a set of unified best practices. Finance Ministers should assess the adequacy of these proposals, drawing upon the analysis of regulators, the expanded FSF, and other relevant bodies.

Medium-term actions

- The key global accounting standards bodies should work intensively toward the objective of creating a single high-quality global standard.
- Regulators, supervisors, and accounting standard setters, as appropriate, should work with each other and the private sector on an ongoing basis to ensure consistent application and enforcement of high-quality accounting standards.
- Financial institutions should provide enhanced risk disclosures in their reporting and disclose all losses on an ongoing basis, consistent with international best practice, as appropriate. Regulators should work to ensure that a financial institution' financial statements include a complete, accurate, and timely picture of the firm's activities (including off-balance sheet activities) and are reported on a consistent and regular basis.

Enhancing Sound Regulation

Regulatory Regimes

Immediate Actions by March 31, 2009

- The IMF, expanded FSF, and other regulators and bodies should develop recommendations to mitigate pro-cyclicality, including the review of how valuation and leverage, bank capital, executive compensation, and provisioning practices may exacerbate cyclical trends.

Medium-term actions

- To the extent countries or regions have not already done so, each country or region pledges to review and report on the structure and principles of its regulatory system to ensure it is compatible with a modern and increasingly globalized financial system. To this end, all G-20 members commit to undertake a Financial Sector Assessment Program (FSAP) report and support the transparent assessments of countries' national regulatory systems.
- The appropriate bodies should review the differentiated nature of regulation in the banking, securities, and insurance sectors and provide a report outlining the issue and making recommendations on needed improvements. A review of the scope of financial regulation, with a special emphasis on institutions, instruments, and markets that are currently unregulated, along with ensuring that all systemically-important institutions are appropriately regulated, should also be undertaken.
- National and regional authorities should review resolution regimes and bankruptcy laws in light of recent experience to ensure that they permit an orderly wind-down of large complex cross-border financial institutions.

- Definitions of capital should be harmonized in order to achieve consistent measures of capital and capital adequacy.

Prudential Oversight

Immediate Actions by March 31, 2009

- Regulators should take steps to ensure that credit rating agencies meet the highest standards of the international organization of securities regulators and that they avoid conflicts of interest, provide greater disclosure to investors and to issuers, and differentiate ratings for complex products. This will help ensure that credit rating agencies have the right incentives and appropriate oversight to enable them to perform their important role in providing unbiased information and assessments to markets.

- The international organization of securities regulators should review credit rating agencies' adoption of the standards and mechanisms for monitoring compliance.

- Authorities should ensure that financial institutions maintain adequate capital in amounts necessary to sustain confidence. International standard setters should set out strengthened capital requirements for banks' structured credit and securitization activities.

- Supervisors and regulators, building on the imminent launch of central counterparty services for credit default swaps (CDS) in some countries, should: speed efforts to reduce the systemic risks of CDS and over-the-counter (OTC) derivatives transactions; insist that market participants support exchange traded or electronic trading platforms for CDS contracts; expand OTC derivatives market transparency; and ensure that the infrastructure for OTC derivatives can support growing volumes.

Medium-term actions

- Credit Ratings Agencies that provide public ratings should be registered.

- Supervisors and central banks should develop robust and internationally consistent approaches for liquidity supervision of, and central bank liquidity operations for, cross-border banks.

Risk Management

Immediate Actions by March 31, 2009

- Regulators should develop enhanced guidance to strengthen banks' risk management practices, in line with international best practices, and should encourage financial firms to reexamine their internal controls and implement strengthened policies for sound risk management.

- Regulators should develop and implement procedures to ensure that financial firms implement policies to better manage liquidity risk, including by creating strong liquidity cushions.

- Supervisors should ensure that financial firms develop processes that provide for timely and comprehensive measurement of risk concentrations and large counterparty risk positions across products and geographies.

- Firms should reassess their risk management models to guard against stress and report to supervisors on their efforts.

- The Basel Committee should study the need for and help develop firms' new stress testing models, as appropriate.

- Financial institutions should have clear internal incentives to promote stability, and action needs to be taken, through voluntary effort or regulatory action, to avoid compensation schemes which reward excessive short-term returns or risk taking.

- Banks should exercise effective risk management and due diligence over structured products and securitization.

Medium -term actions

- International standard setting bodies, working with a broad range of economies and other appropriate bodies, should ensure that regulatory policy makers are aware and able to respond rapidly to evolution and innovation in financial markets and products.

- Authorities should monitor substantial changes in asset prices and their implications for the macroeconomy and the financial system.

Promoting Integrity in Financial Markets

Immediate Actions by March 31, 2009

- Our national and regional authorities should work together to enhance regulatory cooperation between jurisdictions on a regional and international level.
- National and regional authorities should work to promote information sharing about domestic and cross-border threats to market stability and ensure that national (or regional, where applicable) legal provisions are adequate to address these threats.
- National and regional authorities should also review business conduct rules to protect markets and investors, especially against market manipulation and fraud and strengthen their cross-border cooperation to protect the international financial system from illicit actors. In case of misconduct, there should be an appropriate sanctions regime.

Medium -term actions

- National and regional authorities should implement national and international measures that protect the global financial system from uncooperative and non-transparent jurisdictions that pose risks of illicit financial activity.
- The Financial Action Task Force should continue its important work against money laundering and terrorist financing, and we support the efforts of the World Bank - UN Stolen Asset Recovery (StAR) Initiative.
- Tax authorities, drawing upon the work of relevant bodies such as the Organization for Economic Cooperation and Development (OECD), should continue efforts to promote tax information exchange. Lack of transparency and a failure to exchange tax information should be vigorously addressed.

Reinforcing International Cooperation

Immediate Actions by March 31, 2009

- Supervisors should collaborate to establish supervisory colleges for all major cross-border financial institutions, as part of efforts to strengthen the surveillance of cross-border firms. Major global banks should meet regularly with their supervisory college for comprehensive discussions of the firm’s activities and assessment of the risks it faces.
- Regulators should take all steps necessary to strengthen cross-border crisis management arrangements, including on cooperation and communication with each other and with appropriate authorities, and develop comprehensive contact lists and conduct simulation exercises, as appropriate.

Medium -term actions

- Authorities, drawing especially on the work of regulators, should collect information on areas where convergence in regulatory practices such as accounting standards, auditing, and deposit insurance is making progress, is in need of accelerated progress, or where there may be potential for progress.
- Authorities should ensure that temporary measures to restore stability and confidence have minimal distortions and are unwound in a timely, well-sequenced and coordinated manner.

Reforming International Financial Institutions

Immediate Actions by March 31, 2009

- The FSF should expand to a broader membership of emerging economies.
- The IMF, with its focus on surveillance, and the expanded FSF, with its focus on standard setting, should strengthen their collaboration, enhancing efforts to better integrate regulatory and supervisory responses into the macro-prudential policy framework and conduct early warning exercises.

- The IMF, given its universal membership and core macro-financial expertise, should, in close coordination with the FSF and others, take a leading role in drawing lessons from the current crisis, consistent with its mandate.
- We should review the adequacy of the resources of the IMF, the World Bank Group and other multilateral development banks and stand ready to increase them where necessary. The IFIs should also continue to review and adapt their lending instruments to adequately meet their members' needs and revise their lending role in the light of the ongoing financial crisis.
- We should explore ways to restore emerging and developing countries' access to credit and resume private capital flows which are critical for sustainable growth and development, including ongoing infrastructure investment.
- In cases where severe market disruptions have limited access to the necessary financing for counter-cyclical fiscal policies, multilateral development banks must ensure arrangements are in place to support, as needed, those countries with a good track record and sound policies.

Medium -term actions

- We underscored that the Bretton Woods Institutions must be comprehensively reformed so that they can more adequately reflect changing economic weights in the world economy and be more responsive to future challenges. Emerging and developing economies should have greater voice and representation in these institutions.
- The IMF should conduct vigorous and even-handed surveillance reviews of all countries, as well as giving greater attention to their financial sectors and better integrating the reviews with the joint IMF/World Bank financial sector assessment programs. On this basis, the role of the IMF in providing macro-financial policy advice would be strengthened.
- Advanced economies, the IMF, and other international organizations should provide capacity-building programs for emerging market economies and developing countries on the formulation and the implementation of new major regulations, consistent with international standards.

Appendix 2

Meeting of Finance Ministers and Central Bank Governors, United Kingdom, 14 March 2009

We, the G20 Finance Ministers and Central Bank Governors, met today to prepare for the Leaders' London Summit. We agreed further action to restore global growth and support lending, and reforms to strengthen the global financial system.

Restoring Global Growth

1. We have taken decisive, coordinated and comprehensive action to boost demand and jobs, and are prepared to take whatever action is necessary until growth is restored. We commit to fight all forms of protectionism and maintain open trade and investment.

2. Our key priority now is to restore lending by tackling, where needed, problems in the financial system head on, through continued liquidity support, bank recapitalisation and dealing with impaired assets, through a common framework (attached). We reaffirm our commitment to take all necessary actions to ensure the soundness of systemically important institutions.

3. Fiscal expansion is providing vital support for growth and jobs. Acting together strengthens the impact and the exceptional policy actions announced so far must be implemented without delay. We are committed to deliver the scale of sustained effort necessary to restore growth, and call on the International Monetary Fund (IMF) to assess the actions taken and the actions required. We will ensure the restoration of growth and long-run fiscal sustainability.

4. Interest rates have been cut aggressively in most countries, and G20 central banks will maintain expansionary policies as long as needed, using the full range of monetary policy instruments, including unconventional policy instruments, consistent with price stability.

5. We are committed to helping emerging and developing economies to cope with the reversal in international capital flows. We recognise the urgent need to pursue all options for mobilising International Financial Institution (IFI) resources and liquidity to finance countercyclical spending, bank recapitalisation, infrastructure, trade finance, rollover risk and social support. We agreed on the urgent need to increase IMF resources very substantially. This could include further bilateral support, a significantly expanded and increased New Arrangements to Borrow (NAB), and an accelerated quota review. We should also ensure that all Multilateral Development Banks have the capital they need, beginning with a substantial capital increase for the Asian Development Bank, and put it to best use to help the world's poorest. We welcomed the progress by the IMF and World Bank in introducing new and enhanced instruments, including the development of a new high-access, quick-disbursing precautionary facility.

Strengthening the Financial System

6. To further strengthen the global financial system we have completed the immediate steps in the Washington Action Plan and we welcome the Financial Stability Forum's (FSF) expansion to all G20 members. We remain focused on the medium term actions, and make recommendations to the London Summit to ensure:

- all systemically important financial institutions, markets and instruments are subject to an appropriate degree of regulation and oversight, and that hedge funds or their managers are registered and disclose appropriate information to assess the risks they pose;
- stronger regulation is reinforced by strengthened macro-prudential oversight to prevent the build-up of systemic risk;
- financial regulations dampen rather than amplify economic cycles, including by building buffers of resources during the good times and measures to constrain leverage; but it is vital that capital requirements remain unchanged until recovery is assured; and,
- strengthened international cooperation to prevent and resolve crises, including through supervisory colleges, institutional reinforcement of the FSF, and the launch of an IMF/FSF Early Warning Exercise.

7. We have also agreed to: regulatory oversight, including registration, of all Credit Rating Agencies whose ratings are used for regulatory purposes, and compliance with the International Organisation of Securities Commissions (IOSCO) code; full transparency of exposures to offbalance sheet vehicles; the need for improvements in accounting standards,

including for provisioning and valuation uncertainty; greater standardisation and resilience of credit derivatives markets; the FSF's sound practice principles for compensation; and the relevant international bodies identify non-cooperative jurisdictions and to develop a tool box of effective counter measures.

8. To strengthen the effectiveness and legitimacy of the IFIs we must enhance their governance and ensure they fully reflect changes in the world economy. Emerging and developing economies, including the poorest, should have greater voice and representation and the next review of IMF quotas should be concluded by January 2011. The package of quota and voice measures decided in April 2008 should be swiftly implemented. World Bank reforms should be completed by the Spring Meetings 2010. The heads of the IFIs should be appointed through open, merit based selection processes.

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