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THE PITTSBURGH G20 CHECKLIST

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Highlights

- The Pittsburgh G20 may represent the last real chance of shaping and embedding global financial reform - the window of opportunity for action by world leaders is about to close.

- The prime challenge for G20 leaders is to strengthen the stability of the financial sector while preserving free and competitive financial markets and avoiding direct micro-management. Their agenda and language at Pittsburgh will reveal if they have succeeded.

- Equally vital, G20 leaders should strengthen the new global financial governance framework - G20 on top acting through their ministers, with the Financial Stability Board and the IMF reporting to the G20 - by announcing regular G20 meetings and formalising a clear delegation and reporting structure.

- On current-account balances, G20 leaders should decide on an IMF-led framework for monitoring, preventing and containing the development of future imbalances.

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INTRODUCTION

On 24 September the G20 leaders will reconvene in the North-American city of Pittsburgh for a new round of talks on economic and financial issues. Two main questions on the agenda: what (more) needs to be done to re-emerge from the worst crisis since the Great Depression, and how global finance needs to change to prevent similar crises occurring again. These last two years, as painful as they have been, leave behind a rich legacy of experience on how modern financial systems work and may fail. This is useful in designing a coherent reform programme, but not enough to move forward. Behind a web of technicalities, financial sector reform is an inherently political process; providing impulse and guidance for action is the challenge the leaders face in this important meeting.

In spite of its high stakes, the summit is attracting little attention and expectations are low. National debates are concentrated on other issues – health reform in the US; electoral uncertainty and other malaises in Europe; the social costs of the recession everywhere – only indirectly related to financial reform. Public opinion, though deeply sensitive to parts of the agenda, is largely unaware of the upcoming meeting; even economists are distracted, in spite of their calls to 'draw lessons from the crisis'. In the financial markets there is a tangible desire to move on, restart the music and resume the party. The 'back-to-normal' atmosphere risks extending to policy circles, where the comfort of routine is always a temptation. In this context, Pittsburgh may represent in many ways a *last chance*; the window of the leaders' attention seems about to close, and the task of financial reform about to move back to a more technical level.

Between this challenge and their many constraints, leaders will need to compromise between ambition and realism. Objectives will have to be concrete, focused, grounded in a shared interpretation of the recent experience, and commensurate to the available political capital. No grand designs – akin for example to a new Bretton Woods-like agreement – appear feasible or necessary at this stage. One risk is in fact that, as the convoy of post-crisis reform approaches its last stop at Pittsburgh, over-ambition and conservatism, apparently battling on opposite fronts, may reinforce each other, weakening the outcome and producing the essential preservation of the status quo. An even more serious one is that attention may focus on specifics, perhaps politically appealing, while the broad picture is lost.

In this context it is useful to sketch a list of what Pittsburgh may reasonably achieve. The following are some personal views limited to the key focal area of financial reform, leaving out themes that, though likely to feature in the discussions, are relatively peripheral (for example the design of exit strategies, or climate change). My shortlist of potential 'deliverables' includes the following:

1 **Restore confidence in free (but well functioning) financial markets.** The leaders' deliberations and public communication will

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signal how far governments wish to go in broadening their command over the financial sector. The challenge is to strengthen its stability while preserving free and competitive financial markets and avoiding direct micro-management.

2 **Enhance global financial governance.** The institutional changes of the last two years go quite far in the right direction. The new governance framework, with the G20 leaders on top acting through their ministers, the Financial Stability Board (FSB) and the IMF, should be strengthened by announcing regular meetings of the G20 leaders and establishing a clear delegation and accountability framework.

3 **Deal with systemic risk in the financial sector.** The creation of new bodies to monitor systemic financial risks is already underway in both Europe and the US. The leaders can contribute by strengthening their cross-border consistency and the cooperation between them and with other bodies.

4 **Reshape micro-prudential regulation.** In this very technical area leaders can contribute predominantly by establishing or restating broad principles and delegating, mainly to the FSB.

5 **Create a framework to cope with global imbalances.** Large and persistent current-account imbalances were among the factors contributing to the crisis. There are signs that they may rise again. Leaders should re-take the initiative by establishing through the IMF a framework for monitoring, preventing and controlling the development of imbalances in the future.

BALANCING FREE MARKET AND STATE CONTROL

After a wave of deregulation in the last quarter century, the climate has changed: there is now much support for a return to heavier regulation and controls in the financial sector. Will this happen, and where will it lead? In spite of their complexity these questions cannot be ignored because they are implicitly behind some key issues to be discussed at the summit. The challenge here is eschewing ideology and preconceived arguments, and making sure that any new (hopefully better) regulation is based on a shared and sound interpretation of the recent experience. Deliberations and communication by the leaders will, in this respect, provide important signals.

Two examples can help make the point. Fingers have repeatedly been pointed at financial derivatives, accused in general of being a means of unproductive speculation and a source of systemic risk. Credit default hedging instruments were indeed a component of the rapid spread of new risk-sharing instruments that preceded the turmoil. What critics rarely mention is that the predominant part of the derivative markets, those for hedging interest-rate and exchange-rate risk, have continued to operate smoothly throughout the crisis despite the large and unpredicted changes in both interest and exchange rates during the period. These long-standing derivative markets and their infrastructures have created no systemic risk. Problems arose for over-the-counter instruments such as credit default swaps and options, subject to counterparty risk due to the absence of central clearing arrangements. The appropriate response is to identify ways to make derivative instruments more transparent and safer, eschewing indiscriminate judgements and even more mandatory (and ineffective) restrictions on certain instruments or transactions. This is a technical task on which financial regulators are at work: witness for example the initiatives undertaken recently in the US and under discussion in Europe to introduce for credit risk derivative instruments the use of central clearing counterparties and margin calls, as in the more traditional derivative contracts. Any opposition to these reforms from the financial industry should be firmly resisted.

A much more delicate issue relates to the possibility of applying restrictions or guidelines on the compensation of financial managers. It is a fact that the post-1980s deregulation was accompanied (and perhaps, in part, caused) by a sharp increase in managerial compensation, everywhere but in finance particularly. Typically, the distribution of individual rewards has been heavily and increasingly skewed towards the extremes. Whether this was necessary to provide the right incentives and justified by the returns obtained by managers for their companies is controversial. Many believe it was not. A more pragmatic question is how much can usefully be achieved by top-down restrictions that, by their nature, are crude and easy to elude. Another approach consists in empowering the corporate boards and other internal controls, perhaps using internationally agreed principles as a guide – the FSB has recently published a document on this. Too often, administrative boards fail to exercise sufficient scrutiny over managerial compensation levels, either because they are captives of management or on account of other less easily identifiable concerns. Rewarding longer-term corporate performance serves the company itself by making it safer and sustainable, not only the general public or the taxpayer; this should be more generally understood. Financial supervisors can monitor the decisions of corporate boards and exercise moral suasion if needed.

These examples and other similar ones highlight the risks of overreaction in the regulatory response. Direct measures of compulsion are easily circumvented, as experience demonstrates, particularly in financial markets. But this is not the only danger. They are also likely to weaken individual and corporate responsibility and accountability, the very elements that one should strengthen. A risk manager applying a mechanical rulebook or a financial officer subject to extensive controls will probably, after these have been complied with to the satisfaction of their boards, feel less responsible for the company's overall risk profile. A compensation committee that has fulfilled all legal requirements in designing its top managers' bonus structure, possibly using any available loopholes, will regard all other concerns about rewarding risk awareness as redundant. Corporate responsibility and accountability are essential components of a stable and smooth-functioning financial system. They should be fostered through all means.

Though national regulators are ultimately responsible in their jurisdictions, regulatory arbitrage will tend to exert pressure towards a similar regulatory stance. The leaders in Pittsburgh can set the tone here. Success will require, in this respect, striking a delicate balance between what national constituencies demand – often tighter or punitive regulation – and what stands a good chance of being effective and avoiding collateral damage. On financial reform, deliberations and communication by the leaders can best consist of establishing guiding principles and objectives rather than of binding micro-decisions. Building the appropriate incentive structure and monitoring its performance are tasks better left to regulators and supervisors and their international coordination fora – mainly the FSB, the committees of supervisors and other standard-setting bodies. This does not exclude (actually it requires) close control of the process by leaders and their ministers through regular reporting.

ENHANCING GLOBAL GOVERNANCE

The years preceding the crisis witnessed a further acceleration of the degree of interdependence of the international financial system. The integration process had been in motion for decades, as is well known, with two phenomena advancing in parallel. First, national systems have become more interconnected with the increased volume of international capital flows in industrialised as well as in emerging countries. Second, large financial institutions (banks, institutional investors) progressively expanded their cross-border activities. The two processes are self- reinforcing: on the one hand large financial institutions operating across borders are engines of capital flows; on the other the diversification of portfolio holdings by households and firms requires, and gives rise to, the presence of geographically diversified financial players.

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The acceleration is not surprising in the light of other simultaneous changes in the financial markets. The decade preceding the crisis saw a remarkable expansion of risk-sharing techniques and instruments. In a way, this crisis *is* a crisis of risk sharing, not in the sense that financial diversification is harmful but that its implications need to be better understood and controlled. A major channel was credit derivatives. By separating credit from other financial risks and transforming them into separately tradable components, credit default swaps and other related instruments have added a new important dimension to the geographical diversification of risks, within and across borders. Securitisation compounded the phenomenon by transforming traditional retail instruments, such as mortgages or personal loans, into widely distributed negotiable securities. These developments have, besides weakening bank monitoring, also contributed to a much more interconnected financial system (across institutions and across frontiers).

Setting aside any self-defeating financial protectionism, the regulatory response to these developments should be a corresponding increase in the cooperation among financial regulation and supervision authorities, in different forms: from mere information exchange among authorities through cooperation to a sharing of objectives and instruments. The reason is simple: financial interdependence implies that the domestic financial environment, shaped by national regulation, can increasingly affect market participants residing in other jurisdictions, without the control of their respective regulators. Only systematic coordination among authorities (leading in certain respects to a single authority) can correct for the asymmetry. The most frequently voiced objection against close supervisory harmonisation – that budgets for financial rescues belong to the national taxpayer and are ultimately governed by national politics – loses its force in a globally integrated financial market. Benefits and costs from last-resort lending or other types of rescue extend to non-residents anyway, hence the link between supervisory responsibilities and bearing the cost of their potential failure is severed anyway. Virtually all recent episodes of instability or failure of major financial institutions have involved cross-border players. Making international supervisory cooperation consistent with having national public budgets requires, among other things, the definition of mutually agreeable burden-sharing arrangements to be applied when public support is provided to large cross-border conglomerates.

Remarkably, many institutional changes occurring in the last two years have been consistent with this reasoning. Three of them are particularly important.

First, at an early stage of the crisis, in October 2007, the ministers and governors of the G7 decided to entrust the coordination of the crisis-management response to an international body, the Financial Stability forum (FSF), composed of the financial market authorities (ministries of finance, central banks and securities market regulators) of the G7 countries and other systemically relevant financial centres. Created in the aftermath of the Russian crisis in 1998, the FSF had for years remained a secluded forum among financial officials, with little decision-making or coordination ambitions. The crisis changed its role markedly. After October 2007, the FSF took a leading role in organising the regulatory response to the crisis, delivering, in April 2008, a comprehensive list of recommendations addressed to national and international financial regulators. At the IMF Spring meetings of 2008, the G7 endorsed the recommendations and asked the FSF itself to monitor their implementation. A new process of international financial governance, rather technical in nature but unprecedented in substance, was starting.

Second, after the serious aggravation of the crisis in September 2008, the leaders of the G20 decided at the initiative of the US to convene a meeting in Washington to discuss the situation and formulate a shared policy response. Extending participation to the main emerging nations marked a historical transition from the G7 to the G20 as the centre of global financial governance. In an unusually detailed concluding document, the G20 leaders endorsed the proposals of the FSF and converted it into a new formation, the Financial Stability Board (FSB), including the emerging nations. From then on the FSB would report to the G20. Shortly afterwards, a similar extension was decided for another key international regulatory forum, the Basle Committee on Bank Supervision (BCBS), responsible for setting minimum international bank capital standards.

The third development was the decision, adopted at the following G20 leaders meeting in London (April 2009), to strengthen the mandate and governance and to increase the resources of the International Monetary Fund. The IMF, which had just completed a radical (and, one may say, rather untimely) downsizing exercise, was given new responsibilities in managing the macroeconomic policy response to the crisis, in collaboration with the FSB. The IMF was to enhance its capabilities in analysing and monitoring financial sectors, using its comparative advantages: country surveillance, macroeconomic analysis, policy advice and lending, supported by conditionality.

Seen in combination, the three steps – launch of the FSF-FSB process, upgraded G20 and stronger role for the IMF – amount to a significant strengthening and rationalisation of the international financial architecture. Legitimacy increases because of the stronger voice and responsibility of emerging countries at the top (G20 leaders) and at the technical level (FSB and the related standard-setting bodies). Accountability is enhanced because the three main actors have a more consistent geometry: the IMF and the FSB, both with broad representation, will respond to an equally representative 'principal', the G20. This contrasts with the pre-2007 situation when, in many ways, delegation ran from the G7 to the IMF, bodies with widely different representation. The combination of the three should also be more effective than in the past in view of the strong mandate received by the FSB (in fact before October 2007 the FSF) in coordinating the actions of national and international regulators.

Can this system work? Built hastily in an emergency, will it also be effective in normal times? Here is where political guidance will be essential. The G20 summit should become a regular event, with its own established working arrangements. A key to success is in the different roles the participants should play in the new architecture: the leaders as ultimate source of decision-making and (when necessary) compromise; the ministers in charge of monitoring execution; and the two executive arms, FSB and IMF, actually implementing the decisions and ensuring the necessary cooperation at the national level. In Pittsburgh the leaders can further strengthen the overall structure by announcing explicit lines of delegation to this effect.

Rules governing cooperation between the IMF and FSB need to be built. Their structures and missions are naturally complementary but also contain potential overlaps and tensions. Their different forms of organisation (the first, a supranational organisation with a strong staff, the second an intergovernmental body with a small technical

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secretariat) and expertise (macro-policy oriented the first, more micro prudential the second) contain synergies. To exploit them, for each decision or line of work the respective roles should be clarified *ex ante*, based on comparative advantage: who leads and who supports, who is ultimately accountable and in what form. A direct line of reporting from the two bodies to the top level, in addition to ministers, is necessary in order to strengthen accountability and ensure that leaders receive all necessary technical input.

DEALING WITH SYSTEMIC RISK

The renewed emphasis by policymakers on 'systemic stability' is one of the most important consequences of the crisis. Some isolated voices – a few academics and, notably, the economists at the Bank for International Settlements – had flagged the growing presence of systemic risks in the international financial system in recent years, offering evidence and recommendations, but the warnings were largely ignored or underestimated. This is changing now, opening the way to important developments in the conduct of prudential supervision and in its interaction with other economic policies. The traditional macro-policy architecture, which seemed to have reached a stable and accepted configuration in recent years, is evolving again.

Systemic risk arises when actions of individual market participants have adverse effects on the financial system as a whole. In normal times, financial institutions protect their balance sheet with a variety of safeguards, voluntarily or imposed by regulation: capital buffers, exposure or concentration limits, free or required reserves, and so on. Capital requirements are typically determined on the assumptions that the rest of the system remains stable, that asset price volatilities are constant or predictable, and that financial markets remain functional, so that assets can be bought and sold in the market at all times. The crisis has demonstrated how implausible these assumptions are under stress. They break down, for example, when individual reactions – for example, fire sales of securities or early liquidation of lending positions – generate chain reactions by others, with negative effects on asset prices. This is likely to happen when markets are dysfunctional, very thin or illiquid, perhaps due to an abnormal degree of counterparty risk.

One consequence of bringing systemic risk into the picture is that the traditional boundaries between macroeconomic policies and prudential supervision become blurred. Instability in the financial sector can affect the macro-economy; in turn, macroeconomic conditions influence financial stability by affecting bank balance sheets. Traditionally, monetary, fiscal and supervisory policies were designed to operate separately and be conducted by different authorities, each with its own specific set of instrument and objectives. Even when the responsibilities are reunited under a single institution, for example when central banks conduct banking supervision as well, the two functions are typically carried out separately within the same house, using different data and models, largely by different people separated by informational firewalls. Accounting properly for systemic stability implies, instead, accepting a degree of interaction and interdependence between different policy functions.

Another consequence relates specifically to monetary policy. As confirmed by a growing body of analysis, the prolonged period of monetary expansion experienced at the global level in the decade preceding the crisis is a factor that contributed, among others, to the build-up of systemic risk. Abundant liquidity and low interest rates encourage the accumulation of leveraged positions and excessive risk taking in the financial sector. It is wrong to say, as some do, that monetary policy alone (by the Fed or others) caused the crisis. But it was surely among the bundle of contributory factors. Risk in the financial markets mounted during the early part of this decade in a nearly ideal macroeconomic environment, with high growth and stable prices. This apparent 'paradox' suggests that the traditional monetary frameworks like inflation

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targeting, prescribing that central banks should concentrate on delivering low and stable inflation at near horizons, are not sufficient safeguards against economic instability. Rethinking is necessary.

These changes in the traditional policy architecture will only happen gradually. However, some important institutional steps have already been undertaken, with Europe and the US taking the lead.

In Europe, finance ministers, endorsing the recommendations of the high-level group chaired by Jacques de Larosière, have decided to create a new European Systemic Risk Board (ESRB) at European Union level, with a predominance of central bankers but open to the participation of national and European financial authorities. The Board will monitor developments in financial markets from a systemic perspective, issue risk warnings and formulate recommendations to pertinent authorities regarding intervention needed to maintain the stability of the EU financial system. The Board will liaise with other competent authorities at the global level, such as the IMF and the FSB. After a period of preparation, the Board is expected to begin work in the course of next year.

In the US, the Obama administration has proposed a blueprint, currently in Congress, that includes the creation of a new Financial System Oversight Council, chaired by the Treasury and open to the participation of the Fed and other main federal financial authorities. Its tasks are comparable to those of the ESRB, namely to identify emerging systemic risks and the necessary policy responses. Importantly, unlike in the EU plan, the Fed will assume direct supervisory responsibility over all systemically relevant financial entities. This means that this Council will not just issue policy recommendations but will be in a position to execute them directly through one of its key members, the Fed. Though the EU and the US plans contain relevant differences, they share the central notion of controlling for systemic risks and assigning a key role to central banks for this purpose.

Though the reform process in this area is already underway, further political guidance and mandate, also from Pittsburgh, will be useful. Two aspects in particular deserve consideration. First, promoting systemic stability will require strong cooperation among authorities (central banks, finance ministries, securities and insurance regulators) that are accustomed, by tradition and culture, to act autonomously and separately. Political influence, through the proper channels, will be necessary to bring this cooperation about. Second, the competent national structures will have to conduct a constant dialogue at a global level. Systemic risk by its very nature is transmitted across borders, and the responsible institutions will not be able to operate without a full sharing of information. A primary role for central banks, given the multiplicity of cooperation fora existing for related purposes, should help this cooperation.

RESHAPING PRUDENTIAL REGULATION

The micro-prudential reform agenda is a composite mix, with each chapter having its own degree of complexity and controversy. Much has already been done or is underway by regulators and central bankers organised in several international fora. Leaders should ideally avoid a hands-on stance and choose instead to indicate principles, leaving details to substructures such as the FSB. In practice, this is unlikely to happen completely. Banking regulation has entered the public debate and some aspects (like managerial compensation) have acquired symbolic value. The relationship between banks and citizens, in their dual role of bank customers and taxpayers, has become strained everywhere. In this context, the challenge for leaders will be to foster balanced progress, ensuring that the agenda is brought forward effectively and evenly. A danger is that the line of least resistance be taken, with avenues enjoying public support being pursued and others equally important but less appealing or more controversial lagging behind.

Financial regulators and central banks started to coordinate early after the crisis started within the FSF, working simultaneously on several fronts. Since the outset, the main focus has been on three areas: risk control (including capital regulation, liquidity ratios and other risk control instruments, internal risk management, etc.), market transparency (including corporate communication, disclosure policies, accounting standards, the role of credit-rating agencies, etc.), and public action to prevent and control market risks (involving *ex-ante* monitoring, stress testing, strengthening of market infrastructures, crisis management, etc.). For each of these areas a number of recommendations were formulated by the FSF, endorsed by the G7 at the Spring 2008 IMF meetings. Since then the FSF has monitored implementation, reporting periodically, and has itself conducted work on specific issues.

Since this is a crisis originating essentially in an excessive build-up of risk, it is not surprising that the issue of capital adequacy and risk controls is on top of the agenda. The consensus is now to correct for pro-cyclicality of capital regulation, inducing banks to accumulate capital resources in good times, and to ensure an adequate average capitalisation to the system as a whole. If banks are to have an adequate capital cushion in economic downturns (at least not worse than at present), meeting the two requirements implies everywhere an increase in the average rate of capitalisation. The new bank capital standards should achieve this outcome as soon as economic conditions permit, encouraging subscription of new capital from the market to the extent possible but not excluding the public sector. Considering that the need for recapitalisation arises in part from the objective of containing systemic risks, there is no reason to exclude state intervention a *priori*. A similar argument applies, in particular, to systemically relevant banks.

Recently the BCBS agreed on principles and objectives for the new capital requirements, and an integrated proposal should be finalised very soon. It also agreed on specific proposals regarding capital surcharges on certain activities (securitisation, structured products and off-balance sheet activities). In addition to capital-isation, other aspects concerning bank balance- sheet structures have revealed their importance during the crisis. Adequate liquidity margins, in par-ticular, can become a crucial condition for survival in times of stress, even for well capitalised banks, particularly if the maturity of funding is short relative to that of other risky assets.

Another area where conflicts of objectives may arise is that of accounting. Mark-to-market rules have been recognised to be a contributor to pro-cyclicality: write-downs during asset-price declines can induce or force further asset sales that may exacerbate the adverse impact on the market. Recognising this danger, recent changes in accounting standards in the US and elsewhere have introduced more flexibility and discretion in valuation policies by banks. Though temporary and limited departures from mark-to-market may bring relief in certain circumstances, they risk obscuring elements of information that other accounting methods cannot provide. They can also discourage necessary adjustments and cleaning-up of balance sheets.

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In the third area, that of crisis prevention and crisis management, significant progress has already been achieved. In the US, the decision to create a central counterparty for credit derivatives should contribute to removing one of the main elements of stress experienced during the crisis. On *ex-ante* monitoring, progress is underway on stress-testing models, though the construction and maintenance of adequate databases for this purpose remains a challenge. Conversely, concrete action to mitigate the too-big-to-fail problem, so acute recently, is still to be agreed upon. This will require both *ex-ante* agreed resolution procedures for all large systemic financial conglomerates ('living wills', or 'bank hospitals') and burden-sharing arrangements for those operating cross-border.

All in all, the main lines of action have been started and are being implemented, by the FSB in collaboration with other international bodies and national authorities. In Pittsburgh and beyond, the leaders will need to ensure full and timely implementation. Support by ministers in monitoring progress will be essential.

A FRAMEWORK FOR GLOBAL IMBALANCES

Among all issues recently debated in international economics, that concerning global imbalances has been the most vexed (and embarrassing) for economists and policymakers. The difficulty of dealing with the problem was matched only by that of agreeing on its causes and consequences. After several years of near-equilibrium, the US current-account deficit expanded sharply in the late 1990s and reached a peak in 2006, with Japan, the oil exporters and China as its main counterparties. After 2006 the problem, while persisting, changed somewhat; a small reduction of the US deficit was offset by a sharp rise of the surplus of China and some others. Interestingly, the public attention devoted to imbalances did not develop in line with their size. As a Google search can show, for example, the frequency of use of the term 'global imbalances' was low until 2004, peaked in 2006 around the IMF meetings and abated thereafter, to rise again only after the outbreak of the crisis. Right at the peak of the phenomenon there were signs of 'fatigue'; imbalances seemed untreatable and perhaps, some argued, they were not so harmful after all.

Standard international portfolio theories suggest that current-account divergences among countries (or areas) with independent monetary and exchange regimes are subject to a spontaneous self-balancing mechanism. When a country runs a deficit, foreign portfolio holders acquire net assets towards that country, largely (it is normally assumed) denominated in its currency. After a while, the reluctance of foreigners to increase such holdings indefinitely results in a net supply in international financial markets, which causes the currency in question to depreciate. Assuming a normal response of trade flows to relative prices, the imbalance tends to be reabsorbed.

This neat scheme did not work this time, because the actors in the game (consumers, wealth-holders, producers, policymakers) had different objectives and priorities on the two sides. An interest in maintaining the status quo developed symmetrically for different reasons. The US was able to prolong its unprecedented phase of economic welfare based on spending, paying with assets (dollars) it produced itself. Emerging economic powers, such as China, could run their supply-side economic development engine based on exports at full speed, delaying the structural and social changes that a transition from a producing-only to a producing-and-consuming society would necessitate. Oil producers, for their part, have always had a low propensity to invest at home. As a result, wealth holdings by surplus emerging countries, mainly accruing to and managed by official entities, automatically headed back to the largest world financial market – the US – in the form of liquid assets and government bonds. With two consequences: the high liquidity of international financial markets and demand for fixed-rate securities kept interest rates low, at both maturity ends; and as long as the mechanism persisted, the international value of the dollar could remain at levels incompatible with readjusting the imbalances. To close the circle, cheap Asian goods converted at undervalued exchange rates helped maintain inflation in the US and elsewhere low and stable, validating, in a classic inflation-targeting mindset, the expansionary policies conducted by central banks.

Whether one should attribute all this to unsustainable expenditure patterns and policies on the deficit side (read: the US) or to excessive savings by surplus countries (China and others) depends a little on which side of the mirror one thinks reality is. The important point is that global imbalances, deprived of their self-balancing properties, needed and still need to be corrected by policy.

In 2006, the IMF embarked on a round of negotiations ('multilateral consultations') among policymakers from the main currency areas (the US, the euro area, China, Japan and Saudi Arabia), with the aim of identifying the main determining factors and agreeing on corrective policies. This process was innovative in many ways. First, the IMF limited participation to a few key players, thereby enhancing efficiency. Second, the direct involvement of the euro area (for the first time recognised explicitly by the IMF as a fully fledged policy actor) was a remarkable move in the right direction. Third, the format was new in itself, involving a sequence of bilateral (with the IMF) and multilateral contacts leading to a set of policy recommendations, reciprocally addressed, to which each side would give support and individually commit. Opinions about the success of this exercise varied, but not for the method it employed. What it lacked was enforcement backed by a clear multilateral political mandate.

It would indeed be good news if the G20 in Pittsburgh could agree on re-launching this process on a new basis. Two novelties since 2006 make this more promising: the existence of a G20 at head-of-state level can provide a mandate and help enforcement, and the IMF can be a stronger leader, particularly once its governance has been reformed. Unfortunately, action on this front does not seem on the cards. Consensus is lacking, and even the IMF seems to be in two minds. As a bare minimum, global imbalances should remain a central part of external communication by the G20. Further preparatory work by the IMF should be encouraged, including the elaboration of alternative policy frameworks.

PITTSBURGH AND BEYOND

The G20 summit is a remarkable entity: the closest approximation ever seen in history to a 'world governing board'. It is also the youngest actor on the international stage. The 19 country leaders (plus the EU) met for the first time in Washington less than a year ago. In retrospect, it is not obvious that the demise of Lehman Brothers should have led, through a chain of events, to the birth of a new international political formation whose hallmark is the strong presence of emerging nations. Neither the origin nor the centre of the crisis, this time, was in the emerging world. Yet it happened - the impending danger delivered a quantum step forward in global financial governance-building and reordering. The new structure now exists and should be used, and not lapse into being a merely formal exercise.

We opened with a warning: the Pittsburgh meeting, taking place while the global economy is re-emerging from the most acute phase of the crisis, may well represent a final opportunity to move forcefully in the direction of international financial reform. We discussed five possible lines of action, defined as the intersection of what should be done to draw positive lessons from the experience and what can be done, given the degree of consensus existing at national and international level.

These actions require sustained commitment and effort; this is why, above all, strengthening the new institutional architecture is important. Transforming the Pittsburgh event from an endpoint to the start of a process is, in a nutshell, the challenge which G20 leaders must meet.