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A New World Economic Order

Overhauling the Global Economic Governance as a Result of the Financial Crisis, 2008–2009

Tapani Paavonen

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Turku, September 23, 2010
Tapani Paavonen

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1. Introduction: Was the Recent Economic Crisis a Turning Point?

The aim of this study

The recent economic crisis, 2008–2009,[1] is commonly characterized as the worst since the Great Depression of 1929–1933. This recent crisis, called also the Great Recession, seems to form a turning-point in the global economic governance and the development of the world economy.

Two critical points of view dominate the developments since Autumn 2008: Firstly, governments and central banks in different countries, under the leadership of the Group of Twenty (G-20) (see pp. 37–39), were capable of taking prompt action against depression. Not only did the political decision makers react to the actual situation but the G-20 undertook to design an ambitious long-term programme to bring the very phenomenon of the business cycle under control at last. The G-20 managed to evoke wide-based international cooperation not only among its twenty members but also among existing international organizations such as the International Monetary Fund (IMF), the World Bank, the World Trade Organization (WTO) and a number of more specific bodies. This is even more astonishing since deregulations have been the recent trend in economic policy. Secondly, the developments since Autumn 2008 have revealed the increasing weight and significance of the emerging and developing economies in the world economy. It has been a gradual, even incremental process, lasting for decades, but during the recent couple of years, a sudden shift seems to have taken place in the apparent "power relations" within the world economy.

The study focuses on the anti-crisis action taken during 2008–2009. Of special interest is the concerted action by the Group of Twenty (G-20) in cooperation with international organizations. The study depicts the G-20 decisions, resolutions etc. as a world-wide stabilization programme, analyzing its content in terms of

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[1] To be accurate, the financial crisis began to unfold in Summer 2007, but its severity became evident only in Autumn 2008; therefore, in this study it is referred to as the crisis of 2008–2009.

the means of stabilization policy and assessing its significance. The three main research questions, apart from giving a general picture of the crisis development, are as follows: *Firstly*, the study strives to specify the scope and nature of the actual crisis management and the role of international action relative to national stimulus policies. An interesting point of view is the relationship between financially strong and financially weak countries. *Secondly*, the study strives to assess which profound systemic changes, if any, the G-20 view implies for the governance system on the world economy. This will be measured through the means of economic policy and the international governance system embraced by the depicted programme. The ultimate aim is to assess whether it really did create preparedness to prevent new global crises from emerging in the future. *Thirdly*, the study strives to assess how the crisis of 2008–2009 restructured "power relations" in the world economy between the traditional advanced countries, on one hand, and the emerging and developing economies, on the other, measured through shifts in relative economic weights and the suggested new distribution of roles in the international economic governance system.

The main sources of the study consist of the documents of the G-20 meetings, reports by the IMF, and statistical material provided by the IMF, the United Nations Statistical Office, the Organization for Economic Co-operation and Development (OECD) and the European Commission.

The subsequent sections of this Introductory chapter deal with the question of whether the business cycle can be brought under control, the means of stabilization policies through which economic fluctuations could be managed, and the global market economy which forms the economic environment of present anti-crisis policies. Chapters 2 and 3 offer the background to the G-20 stabilization programme. Chapter 2 "The Institutional Framework of Global Economic Governance" deals with the international economic organizations through which concerted international action can be carried out. Chapter 3 "Growth and Fluctuations in the World Economy" deals with the emergence of the present situation in world economy during the past decades: the vigorous economic growth with the rise of emerging economies, the return of financial crises within the global market economy and the present global imbalances which exacerbate anti-crisis efforts. Chapter 4 "The Crisis of 2008–

2009" deals with how the US housing market created a world-wide crisis. Chapter 5 "Prompt Stimulus, 2008–2009" deals with how concerted international action managed to prevent a fatal economic depression, confining the crisis to a relatively short-time recession. Chapter 6 "G-20 Design for Global Financial Stability" deals with the long-term G-20 stabilization programme to prevent new financial crises in the future through effective banking regulation. Chapter 7 "Creating the 21st Century Global Economic Order" sums up the research results.

Can the business cycle be brought under control?

There is no consensus among economists on the "cause" or "causes" of business cycles. The two main approaches to explain the business cycle are a monetary and a real-economy one. They can also be characterized as rational explanations. The monetary approach seems to suit the era of "unbridled capitalism" until the Great Depression of 1929–1933, and again the global market economy from the 1980s onwards, while the real-economy approach seems to suit the relatively regulated economy from World War II until the 1980s.

The monetary approach explains the business cycles as pro-cyclical variation in the supply of money. Credit expansion produces an economic boom, while credit losses as a result of vigorous credit expansion force the banks to contract credit with an economic recession and possibly depression as the consequence. Portfolio investments play an important role in the process.

The real-economy approach is mainly related to Keynesian economics. It focuses on the components of aggregate demand, of which investments and exports are the most volatile. The business cycle is explained by the mechanisms of the investment multiplier[2], or briefly, multiplier and accelerator. The multiplier explains how an increase in investment produces an even larger increase in national product through increased consumption demand. The accelerator

[2] Keynes defined: 1 – 1/k = marginal propensity to consume, where k = investment multiplier. Keynes (1936), pp. 114–115; In textbook presentation the formula is transformed to the more comprehensable form: k = 1/(1 – mpc), where k = investment multiplier, mpc = marginal propensity to consume.

explains how increased production and hence increased consumption demand fosters investment. The upward spiral of investment and production continues until the growth pace of consumption slows down, turning investment and production downwards. International trade propagates economic fluctuations from one country to another. For small countries, highly dependent on foreign trade, such as Finland and Sweden, the crucial effective force has traditionally been fluctuations in export demand.[3]

From the 1980s onwards, supply-oriented economics has challenged the demand-oriented explanation of business cycles. According to the Real Business Cycle Theory, variation in aggregate supply, such as technological change, causes cyclical fluctuation in output.[4]

Irrespective of the ultimate or triggering cause, the monetary and real facets are closely intertwined. The historical appearance of each crisis is different. Yet, in terms of key economic indicators since the Great Depression of 1929–1933, as far as comparative statistical data are available, most crises bear astonishingly similar features. An economic crisis is typically preceded by vigorous growth of production fostered by high debt leverage and rising housing, stock and other asset prices. Worst hit are usually those countries which also have accumulated the highest foreign debts. After the peak, the fall of production and asset prices proceeds faster than the preceding rise. After the trough, usually, production and asset prices rise relatively slowly and unemployment rates remain on higher levels than was the case prior to the crisis. A post-crisis deleverage of debt financing usually takes place with delay. High inflation is common in the pre-crisis situation, while a crisis dampens price rises, often even leading to deflation.[5]

Contrary to a popular misconception, the Pure Theory of Economics does not claim that people are always rational but it analyzes how economic actors proceed *when* they behave rationally.

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[3] See, e.g. Kindleberger (1973), pp. 19–30; Kindleberger & Aliber (2005), pp. 21–32; Samuelson & Nordhaus (1989), pp. 171–172, 211–217; For the Swedish-Finnish exports-dependency model, see, e.g. Lindbeck (1968), pp. 63–75; Leponiemi (1978), pp. 128–130.

[4] See, e.g. Samuelson & Nordhaus (1989), pp. 206–207.

[5] For statistical analysis, see Reinhart & Rogoff (2008), pp. 5–12; Reinhart & Reinhart , (2010), spec. pp. 2–4.

There are situations in which actors proceed in an apparently irrational way. Extraordinarily vigorous fluctuations, which occur at times, represent such an occasion.[6] Financial speculation means, for example, that asset values, i.e. prices of stocks, real estates etc., fluctuate in ways not explainable by the Rational Market Hypothesis, according to which asset price should be the sum of interest rate-related future returns.[7] Apparently, there are psychological factors which make people react to changes in an exaggerated way with regard to economic fundamentals.

According to the American economists Hyman Minsky and Charles P. Kindleberger,[8] a financial crisis proceeds through stages as follows: Expansion – Euphoria – Mania – Distress – Panic – Crash – and eventual recovery. Economic expansion, a boom, continues creating an atmosphere of euphoria. Price rises on stocks and real estates seem to continue indefinitely. The boom is accompanied and financed by vigorous credit expansion. Some sceptics may remark that in the past similar situations have led to a crash but the general sentiment is that "this time it's different". Euphoria can develop into mania, when people compete on investment assets. At some stage "insiders" begin to sell their assets – at a profit, followed by "outsiders" – at a loss. Financial distress emerges when large numbers of distress sellers are unable to serve their bank loans. The sellers are more eager than the buyers even though the prices fall. Panic can be triggered by the failure of a bank or manufacturing enterprise, and "the bubble implodes". Scandalous revelations (swindle, fraud) can fan panic further. The result will be an economic crash. Credit contraction belongs to the downward-movement. Eventually, the depression will end and a new recovery will start. A lender of last resort is essential to bring the financial system back into operation in a normal way over a reasonable period of time.

John Maynard Keynes spoke about "animal spirits" in the meaning of "a spontaneous optimism" as the driving force behind go-ahead human action. Thus, "spontaneous urge to action", rather than mathematical calculation, motivates people's economic decisions.[9]

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[6] Cf. Kindleberger & Aliber (2005), pp. 33–38.

[7] Cf. Fox (2009).

[8] Kindleberger & Aliber (2005), pp. 9–12, 21–32.

[9] Keynes (1936), pp. 161–162.

Some Keynesian economists of the early 21st century have revived the concept "animal spirits" to explain the extreme economic fluctuations of the recent period of free financial flows. According to George Akerlof and Robert Shiller, confidence is critical for economic performance. Confidence in the functioning of the system boosts the economy while the crumbling of confidence depresses it. The feeling of fairness is an essential basis for confidence. If measures undertaken in the economy are perceived by the public as fair, the economy develops favourably, while opposite feelings undermine economic performance. Shiller speaks about "social contagion" as the mechanism through which boom and depression sentiments spread in social contacts. A major factor which at times ruins confidence is corruption and bad faith. According to Akerlof and Joseph Stiglitz, securities markets are characterized by asymmetrical information (they were awarded the Nobel prize for this insight). Asymmetrical information enables securities issuers with a better knowledge of the underlying factors to delude their customers – and they do so.[10]

The question of controlling economic fluctuations has been topical since the Great Depression of 1929–1933, which was the last deep depression in economic history and has thus become a benchmark for comprehension of business cycles. In the 1930s, the governments and central banks failed in two ways. On the domestic arena, the governments practised pro-cyclical fiscal policies, which aggravated the situation instead of healing it. To be sure, the central banks, as the general rule, lowered interest rates to stimulate investment. With regard to the international community, "beggar-thy-neighbour" policies were practised instead of international cooperation. National decision-makers strove to transfer domestic depression abroad by customs-tariff increases and competing devaluations of their currencies. The failure of the League of Nations World Economic Conference in 1933 was a manifestation of the incapability of the statesmen and central bankers.[11]

[10] Akerlof & Shiller (2009), spec. pp. 11–56; Shiller (2008), spec. pp. 41–47; Stiglitz (2010), pp. 91, 95 and passim.

[11] Cf. Kindleberger (1973), spec. pp. 108–224, 291–307.

After World War II, endeavours to avoid the errors of the 1930s have dominated business-cycles policies. In many Western countries sophisticated economic-policy instruments were developed to combat depressions through anti-cyclical measures, especially within the domain of national fiscal policies. This policy is strongly connected with J. M. Keynes but has been considerably developed further since his time. Anti-crisis measures were carried out within national frameworks. For example, the famous Swedish stabilization policy of the 1950s and '60s took fluctuations in the world economy as granted and adjusted the national policy to counterweight their impact on the Swedish economy.[12]. Since World War II, by and large, up to the 1980s, world economic growth in the framework of largely regulated and relatively closed national economies was conspicuously smooth, except in connection with the oil crises of 1973–1974 and 1979–1980.

From the 1980s onwards, the world economy has undergone considerable structural changes. A new wave of globalization has created an integrated world market based on virtually free movement of goods, services and capital (but not people). A consequence of this development, during the past roughly 20–30 years, has been that vigorous economic fluctuations and financial crises with severe recessions, even the threat of deep depressions, have returned to the world economy. The crises, however, remained regional until the recent one. (See pp. 48–51.)

Considering the general orientation towards economic deregulations since the 1980s, it may seem surprising that, in Autumn 2008, regulatory economics were quickly adopted by policy makers of the leading industrial countries. The idea of managing cyclical fluctuations, which already seemed to be almost forgotten as economic policy, seems to have experienced a sudden regeneration even as a generally recognized orientation. The prompt concerted action against depression, which was prepared, above all, within the Group of Twenty (G-20), seems to be the most convincing testimony for this. One can, thus, justly ask whether the crisis of 2008–2009 marked a return to economic crisis management but, this time, within a global framework.

[12] See Lindbeck (1968), spec. pp. 63–152.

Taken realistically, it would certainly be an over-optimistic expectation that economic fluctuations could sometimes be eliminated completely. Rather it is a question of preventing unreasonably volatile fluctuations involving financial crises.

The means of stabilization policies

The means of stabilization policies, through which economic fluctuations are tackled, can be divided into monetary and fiscal policies. Monetary policies consist of means which affect the state of the financial market, while fiscal policies operate through public expenditure and public revenue.

For *monetary policies*, the main instrument is the *steering interest rate* or policy interest rate, which is the main interest rate of *open market operations*. The central bank regulates the state of liquidity within the banking system and affects the general level of interest rates by trading with financial institutions in securities on the basis of repurchase agreements. Within the European Central Bank (ECB) system the steering interest rate is called the Main Refinancing Operations or *MRO rate* and within the Federal Reserve System (Fed) the *target federal funds rate*. It is a consolidated norm that in normal times a central bank must not acquire state debt papers directly but only through the medium of commercial banks. The second framework for interest rate instruments, called *standing facilities* within the ECB system and *discount window* within the Fed, supply commercial banks with short-term ("over-night") liquidity. The main purpose of this instrument is to secure the functioning of the interbank market. A third instrument of central bank policies consists of minimum reserve requirements, the purpose of which is to secure the position of the depositors.[13]

Crucial for the state of the financial market are the statutory banking regulations to secure the solvency of financial institutions. The Basel Committee on Banking Supervision (BCBS) (see pp. 34–36) and the Financial Stability Board (FSB) (until 2009 the Financial

[13] See "The Eurosystem's instruments", http://www.ecb.int/mopo/implement/ (January 31, 2010); "About the FOMC", http://www.federalreserve.gov/monetarypolicy/fomc.htm (January 31, 2010); Krugman & Wells & Graddy (2007), pp. 770–773.

Stability Forum, FSF) (see p. 37) strive to harmonize banking regulations on an international scale. A deposit guarantee is legislated to assure the depositors about the safety of their savings, to prevent a so-called bank run – as depositors rush to banks to withdraw their money in cash before it is too late. In the US, the Federal Deposit Insurance Corporation (FDIC) was created in 1933, in the aftermath of the Great Depression; in Europe, a deposit guarantee was introduced mainly in the 1990s.[14].

With regard to modest economic fluctuations, the central banks regulate the financial market through the standard instruments. In times of financial crisis and economic depression, however, the standard means do not suffice to maintain a functioning financial market. For example, the interbank market can be paralyzed in the circumstances of "credit crunch" when the banks do not trust each other's solvency. The main role of the central bank in a financial crisis is to function as the lender of last resort, supplying the financial system with liquidity. Apart from the standard instruments, the central banks can develop new lending facilities within which the conditions of credit are facilitated relative to normal times. The possibilities of monetary policies to remedy an economic depression are, however, limited. Interest-rate reductions do not foster credit demand for investment if entrepreneurs are uncertain about the future returns of their investments. In the case of a banking crisis, the possibilities of central bank policies are limited to remedying or alleviating liquidity problems of solvent banks. The means of fiscal policies, as described below, must be deployed to revive aggregate demand and to restore solvency in the banking sector.

Fiscal stabilization policies strive to counterweight economic fluctuations through counter-cyclical deficits and surpluses in public finance, a principle known as Keynesianism. In times of economic recession and depression the public finance has to resort to borrowing; this debt, according to prudent financial principles, should be repaid during the subsequent upward swing of economic development.

A modern welfare state contains a number of automatic stabilizers which counterweight modest economic fluctuations. Automatic stabilizers consist of social security schemes which expand public expenditure in times of economic recession, while tax revenue

[14] Lybeck (2009), pp. 112–117, 238.

shrinks at the same time, and vice versa during an upward swing. During severe economic slumps, however, automatic stabilizers do not suffice so discretionary stimulus policies are required to revive production and promote employment. The original Keynesian concept emphasized maintaining the aggregate demand through public investment financed by borrowing. In J.M. Keynes's time construction works were labour-intensive. Since unemployment was perceived as the main grievance of depression, Keynes regarded public investment as the most suitable element of aggregate demand to be regulated by governmental fiscal policies. In the modern world with capital-intensive construction, in terms of employment, service projects can be even more suitable as stimulus policies.

Since the possibilities of central bank policies in financial crises are limited to remedying liquidity problems, insolvency problems must be tackled through fiscal means, i.e. by injecting capital into the banking system from governmental budgetary means. Governmental intervention is also necessary to restore the public's confidence in the financial system. The main forms of capital support are recapitalization of financial institutions, governmental guarantees for financial institutions' liabilities and absorbing impaired assets.

Insolvent banks are rescued because they are "too big to fail", i.e. their outright bankruptcy would lead the whole financial system to collapse. From the societal point of view each bank "bailout" involves the eventuality of *moral hazard*, the possibility of gambling for private profit, while the risk of loss is "outsourced" to taxpayers. It is obvious that expectation of a governmental rescue operation in the eventuality of failure tends to encourage excessive risk-taking if the rules of the game include only the profit option for the gambler, while possible losses will be "socialized". "Heads, I win – tails, you lose." The grievance is that almost the whole of the modern banking sector consists of units so large that they are systemically too important to be allowed to go bankrupt.[15]

The state budget, for a federal state the federal budget, is the main instrument of governmental fiscal policies to manage economic fluctuations, while the state of the total public finance is crucial for the over-all economic situation. In statistics, the state/federal

[15] E.g. Krugman (2008), spec. pp. 62–66; Lybeck (2009), spec. pp. 128–129; Stiglitz (2010), spec. pp. 83, 132, 146, 164–168, 278–281.

finance is referred to as the central government balance and the central government debt, while the total public finance is referred to as the general government balance and general government debt, the latter including the federal, state and municipal levels of public administration, as well as the social security funds. Usually the general government deficit and debt are larger than the central government ones; the reverse can be the case if the central government debt is drawn extensively within the public sector itself (mainly from social security funds).

With regard to "debt stimulus", an important point of view is what could be called the "indebtedness allowance" or, reversely, the "sustainability deficiency". Public debt cannot be accumulated indefinitely, at least relative to the national product. There cannot be any fixed criterion in this respect. For comparison, the Finnish state debt in the late 1980s, then a tenth part of the gross domestic product (GDP),[16] or the present Estonian public (general government) debt, 7 per cent of GDP in 2009,[17] can be regarded as ideal for levels of departure for stimulus policies. The reference values for the maximum of public deficit and public debt of the Economic and Monetary Union (EMU) within the European Union, 3 and 60 per cent of GDP, respectively, seem reasonable as an acceptable upper limit. The EMU reference values are defined in terms of general government deficit and debt. (For the EMU reference values, see pp. 58–62.)

Globalization

The characteristic features of the present global economy have emerged approximately from the 1980s onwards, substantially since the end of the Cold War, as a result of the most recent wave of globalization. The development is characterized most conspicuously by the transfer of labour-intensive manufacturing industries, the production of so-called bulk products, from the old industrial countries to low-wage countries. Among advanced countries, the vicinity of market areas can be the main motive for establishing foreign affiliates. With regard to less advanced countries, availability of cheap labour is the main

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[16] See, e.g. "State debt at the end of 1970–1990", *Statistical Yearbook of Finland*, 1991.

[17] See Table 9.

advantage. Another lucrative factor in many host countries is the availability of raw materials. Large-scale foreign direct investment (FDI), which the liberalization of capital movements from the 1980s onwards has enabled, is the other side of this development. The total nominal amount of world FDIs – equivalent to 14 billion US dollars in 1970, 52 billion in 1980, 239 billion in 1990, 1.2 trillion in 2000 and 2.1 trillion in 2007 – corresponded to about half a per cent of world GDP until the mid-1980s, about one per cent until the mid-1990s, and from about 2 to almost 4 per cent in the 2000s.[18]. The general pattern is that net flows go from more advanced to less advanced economies. At the same time, cross-border banking and large-scale international portfolio investments have created an international financial market that is vulnerable to financial crises. The recent development of telecommunication and transportation has further accelerated the globalization process.

The large manufacturing enterprises in the old industrial countries have grown into multinational corporations, which operate, in principle, all over the world. The networks consist of key activities in the home country and affiliates abroad with local subcontractors, who are often traditional craftsmen. Manufacturing production has been transferred, above all, to Asia, Latin America and the transitional economies of Eastern Europe, albeit less to Russia and the other countries of the Commonwealth of Independent States (CIS). Especially China has been noticed in this connection. The networks are expanding continuously to new countries, wherever there is cheap labour and/or raw materials and favourable institutional conditions for business activities. With increased incomes formation as a result of new factories and orders from local enterpreneurs, the host countries also become important market areas, not only sources of factors of production.

At the same time, the world economy was transferred into a more genuine market economy. The advanced Western countries abolished their still existing economic regulations from the 1980s onwards. The Liberal revolution in Eastern Europe, 1989–1991, meant transition from a centrally-planned to a market economy. Since the 1970s, China has been transformed into a mixed economy with conspicuous market-economy features – albeit under a Communist Party dictatorship. The

[18] "Major FDI indicators (WIR 2009)", Foreign Direct Investment database (May 8, 2010).

collapse of Communism in Eastern Europe further spurred movement towards a more clear-cut market economy. The Western countries abolished their regulations, even further, and, for example, India, the second largest country in the world by population, drastically abolished its large-scale regulations in 1991. For the time being, only few countries are outside the extensive economic interaction.

From the viewpoint of the advanced countries, globalization is a framework within which to promote the success of home-based multinational corporations. It is generally deemed that the success of the national economy is firmly bound to the success of the home-based enterprises. If isolated from the general trend of internationalization, the domestic industries would lose their competitiveness. In terms of Michael E. Porter's theory of Competitive Advantage, firms seek advantageous factors of production and favourable operational environments in the global market. The successful firms are those which manage to unbundle their value chains in a rational way. Different phases of value chains are located according to the advantages of the locations.[19] Thus, one consequence for international trade has been, apart from its expansion, that, to a large extent, trade in components has replaced the traditional trade in finished goods.[20]

For the less advanced countries, globalization is a means to promote industrialization and economic growth. The economic theory[21] predicts that economic convergence, in the form of equalization of factor incomes, will proceed within an integrated international economy. This is what is presently taking place. The International Labour Organization (ILO) could play an important role in developing and harmonizing social standards in the emerging and developing economies. Social improvements do not undermine the competitiveness of business firms nor of the host countries as locations for economic activities, provided the competitors are subject to the same regulations. For example, Finland competed successfully in the 1960s and '70s with the comparative advantage of cheap labour in the framework of West European economic integration, while at the same time constructing a welfare state.

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[19] Porter, Michael E. (1998), spec. pp. 33–130.

[20] For the recent globalization process, cf. e.g. Gilpin (2001).

[21] Charles P. Kindleberger defines: "Economic integration is factor-price equalization." Kindleberger & Lindert (1978), p. 179.

2. The Institutional Framework of Global Economic Governance

Intergovernmental governance on global problems

There is a discrepancy between global problems, on one hand, and national and intergovernmental economic governance, on the other. Since World War II, a wide network of international organizations has been developed to manage the problems of the world economy. The terms of reference of different organizations have often been overlapping, and thus their activities have been strongly intertwined. All the world-wide organizations are based on intergovernmental cooperation, within which the member countries, in the last instance, pursue their national interest. Supranational decision-making properly applies only to West European integration in this regional context and even that only partially.

For global economic governance, the most important international organizations are the International Monetary Fund (IMF), the World Bank, and the World Trade Organization (WTO). The Bank for International Settlements (BIS) has mainly complemented the functions of the IMF. The Organization for Economic Co-operation and Development (OECD) has played a crucial role in the international economic development of the past decades, but it covers only the advanced countries, the emerging economies being left outside. Intergovernmental cooperation is not a symmetric relationship among the multitude of world states, but agreements and cooperation among some key states are pivotal for the overall development. During the past decades, such cooperation has been institutionalized within groups of leading states, of which the Group of Eight (G-8) and the Group of Twenty (G-20) are active today.

When the present institutions were created, world production and economic transactions were heavily concentrated in Western Europe and North America, i.e. the strongholds of Western Civilization. After World War II, international economic governance was dominated by the Transatlantic Relationship between the United States and Western Europe until quite recent times. During the Cold War, Western dominance was still emphasized by the exclusion of the Eastern Bloc from the pivotal institutions. Within the post-Cold

War global economy, political antagonisms have mainly ceased to condition international economic relations, while, at the same time, participation in international cooperation has been substantially enlarged.

The universalist design for post-war international economic order

The Bretton Woods organizations: IMF and World Bank

In July 1944, when World War II was still going on, representatives of 44 Allied and neutral countries convened at the United Nations Monetary and Financial Conference at Bretton Woods, near Washington, to solve the problems of post-war international monetary and financial order. The architects of post-war international economic order were critical of old economic doctrines. They were determined to avoid the errors which the statesmen and central bankers had made when handling the Great Depression of the early 1930s. The ambitious goal was to maintain global financial stability and promote economic growth and employment. Fostering international trade was an important means in this respect.

The agreements of the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD) or the World Bank were negotiated at Bretton Woods and signed in 1945. The Bretton Woods organizations began operations in 1947. The preoccupation of the IMF is monetary stability while the World Bank endeavours to promote economic growth. International trade was the preoccupation of what was to be known as the General Agreement on Tariffs and Trade (GATT). Originally, these agreements were envisaged to cover all the United Nations, but as a result of the Cold War confrontation they were limited mainly to the Western world economy. The Soviet Union participated in the Bretton Woods conference and even signed the IMF and IBRD agreements but eventually failed to ratify them.[22]

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[22] Kostecki (1979), pp. 1–3.

Each member country subscribes to a quota in the IMF and to a number of shares in the World Bank commensurate to its relative economic weight. The United States subscribed the largest quota and number of shares. The quotas are to be reviewed at intervals of five years; additionally there are *ad hoc* reviews. A change in the quotas is to be decided by a qualified majority and with the approval of the country concerned. Correspondingly, the capital stock of the Bank can be increased by a qualified majority but a member country is not obliged to participate in the issue of new shares. Voting power is related to capital contribution. Each member was to have 250 basic votes (until the recent governance reform, see pp. 26–29) plus one vote for each 100 000 dollars/SDRs (see pp. 23–24) of its quota in the IMF and 250 basic votes plus one vote for each share in the World Bank.

The first goal of the IMF was to gradually resume a global system of convertible currencies, a precondition for multilateral trade, which had collapsed as a result of depression and war. The IMF Agreement forbids, in principle, all restrictions on current payments but reserved a transitional period for the abolition of existing regulations. Once a member has notified that it will, according to Article VIII, relinquish the restrictions on current payments, it can no longer resort to the transitional reservations of Article XIV. The leading West European countries notified their commitment to the obligations of Article VIII in 1961 but, for example, Finland only in 1979. By now, virtually all countries have given this notification.

The Organization for European Economic Cooperation (OEEC) (1948–1960) and its successor, the Organization for Economic Co-operation and Development (OECD), contributed decisively to the realization of a system of convertible currencies. During 1949–1958, the OEEC countries carried out mutual transferability of export revenues. From 1959 the OEEC countries, followed by Finland, committed themselves to the convertibility of export revenues also with regard to the dollar. Of crucial significance have been the codes of liberalization, one for current invisible transactions (i.e. trade with services) and the other for capital movements, approved within the OECD in 1961 and since then amended repeatedly. The OECD codes

thus presume even more far-reaching liberalization than the IMF stipulations.[23]

The new international monetary system became dollar-centred, since the United States was the indisputable leader of the world economy. The exchange rates were to be fixed but adjustable; the IMF agreement enabled a change in the *pari* value of a currency "to correct a fundamental disequilibrium". The classic gold standard was rejected because of its negative effect on growth and employment. The US dollar was pegged to gold, while the *pari* values of the other currencies were, as a rule, defined in US dollars. The system offered countries other than the United States the possibility to adjust their exchange rates according to balance-of-payments requirements. The United States, for its part, undertook to convert dollars in foreign central banks' possession to gold at the rate of $35 an ounce. Already in the 1960s the system fell into crisis. As a result of large-scale US capital exports, the Treasury no longer managed to redeem the offered amounts of overseas dollars against gold. The Bretton Woods convertibility was suspended in 1971.[24]

The collapse of the Bretton Woods convertibility did not change the basic structure of the dollar-centred international monetary system. The dollar continued to perform, on a global scale, all the three functions of money: medium of exchange, store of value, and unit of account. Since 1971 the position of the dollar as a reserve currency was weakened to some extent but was reinforced again from the 1990s. The dollar has also functioned as the most important anchor currency. From the 1990s a "Bretton Woods II" has emerged as the currencies of a large number of emerging and developing economies, notably in Asia, have been pegged "softly" to the dollar – aiming to maintain a certain exchange rate to the dollar to promote their exports and to maintain their internal price levels. It has been generally assessed that the currencies have been pegged at undervalued rates.[25]

The Special Drawing Rights (SDR) as an international reserve asset was introduced in 1969 to meet the shortcomings in global liquidity which arose during the 1960s. The SDRs are issued by the

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[23] See Tew (1988), pp. 38–40, 47–57, 128–130; IMF, Annual Report 2006, Table II.12.

[24] Tew (1988), pp. 91–109, 120–124, 145–150.

[25] James (2009), pp. 26–29; McKinnon (2009), pp. 47–50, 57–62.

IMF without subscription by member countries but they are allocated to the member countries in proportion to their quotas. Originally, the value of SDR was determined as one US dollar, but when the dollar-gold convertibility ended and the exchange rate of SDR was changed to a currency-basket basis, its value was detached from the dollar. General SDR allocations have taken place three times, most recently in August 2009 as part of the actual G-20 stimulus programme (see p. 90). Additionally, a special allocation was decided in September 1997 and implemented in September 2009, compensating the general allocations to countries that had joined the IMF later. The SDR also became the accounting unit of the IMF.[26]

The permanent function of the IMF is to provide the member countries with financing to cope with temporary balance-of-payments deficits. A member country can draw on the Fund, i.e. borrow[27], in foreign currencies in proportion to its quota. Only recently, during the Asian and Russian financial crises in 1997–1998, the IMF also adopted the role of lender of last resort in a wider scope than the traditional balance-of-payments financing.

Originally, the IMF's only financing resource was the quotas. To meet the increasing financing demands, the capital acquisition of the IMF was augmented by the General Arrangements to Borrow (GAB) in 1962. Within the GAB, the IMF borrows from certain member countries or their central banks. Since 1962 the arrangement has been renewed several times, most recently in 2007. The New Arrangements to Borrow (NAB) became effective in 1998. Within the scheme, the IMF borrows from a number of financially strong countries and institutions. The NAB was last renewed in 2007, and in the crisis of 2008–2009 it was to play an important role for the G-20 in arranging financing for stimulus policies in poorly equipped countries (see p. 90).

The IMF exercises surveillance over the member countries' exchange rate policies and conducts consultations with the member

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[26] Tew (1988), pp. 128–138; "Special Drawing Rights (SDRs). October 31, 2009", https://www.imf.org/external/np/exr/facts/sdr.htm (December 14, 2009).

[27] Drawing on the Fund is defined in the IMF Agreement as follows: "A member shall be entitled to purchase the currencies of other members from the Fund in exchange for an equivalent amount of its own currency (...)." But since the drawing is to be repaid (repurchase its currency) and interest (charge) is to be paid on the drawing, the question is, in fact, about credit.

countries to appraise their economic and financial situation and policies. Conditionality means that a member country which has drawn on the Fund has to adopt a programme to overcome its economic difficulties. In other words, countries resorting to IMF financing become "wards", obliged to comply with the policy requirements determined by the Fund.[28]

The World Bank has granted long-term loans to the member states, first for post-war reconstruction and then for development purposes. During the past decades the Bank has oriented its activities towards the developing and economically less-advanced countries. The funds are raised mainly by issuing and selling securities, i.e. the Bank borrows money to lend it forward.

Apart from the World Bank proper, the World Bank Group includes four additional organizations that perform specialized operations in order to promote economic growth in the developing countries.[29] Multilateral Development Banks (MDBs) is the common designation for the World Bank Group and the four Regional Development Banks. The regional development banks are as follows: the Inter-American Development Bank (IDB), established in 1959 to support development in Latin America and the Caribbean; the African Development Bank (AfDB), established in 1963; the Asian Development Bank (ADB), established in 1966; and the European Bank for Reconstruction and

[28] Tew (1988), pp. 116–118; *The international Monetary Fund* (1980), passim; Kindleberger & Aliber (2005), pp. 13, 180–181, 212–216, 228–234; "IMF Standing Borrowing Arrangements. September 25, 2009", http://www.imf.org/external/np/exr/facts/gabnab.htm (December 14, 2009).

[29] The International Finance Corporation (IFC) was established in 1956 to foster private sector investment in developing countries. The International Development Association (IDA), established in 1960, provides the poorest countries interest-free loans, grants and technical assistance. The International Centre for Settlement of Investment Disputes (ICSID), established in 1966, seeks to remove impediments to private investment posed by non-commercial risks. The Multilateral Investment Guarantee Agency (MIGA), established in 1988, seeks to promote foreign direct investment (FDI) into developing countries by providing guarantees against non-commercial (political) risks to the private sector. *A guide to the World Bank* (2003), pp. 3–23; "About IFC", http://www.ifc.org/ (December 14, 2009); "IDA-International Development Association", http://www.brettonwoodsproject.org/institution/ida/index.shtml (December 14, 2009); "About ICSID", http://icsid.worldbank.org/ICSID/Index.jsp (December 14, 2009); "About MIGA", http://www.miga.org/ (December 14, 2009).

Development (EBRD), established in 1990 to promote transition from a command economy and dictatorship to a market economy and democracy within the space from Central Europe to Central Asia.

The IMF, the MDBs and comparable international institutions established by more than one state are referred to as the International Financial Institutions (IFIs). The MDBs and a number of other organizations[30] are together referred to as the Multilateral Financial Institutions (MFIs). The IFIs and the MFIs consist mainly of the same institutions. The scope of the IFIs is in the stability perspective, while the MFIs focus on the development perspective.[31]

Reform of the Bretton Woods organizations

In the 2000s, the question of a governance reform within the Bretton Woods organizations was raised. As a result of vigorous economic growth in many emerging economies during the past decades, the old industrial countries became over-represented in the Bretton Woods organizations relative to their actual economic weight. Especially Western Europe had become over-represented and Asia under-represented. Representatives of emerging economies have demanded appropriate representation in the governance of the world economy, commensurate to their actual economic weight.[32] Also the practice that a European is appointed as Managing Director of the IMF and an American as President of the World Bank has raised eyebrows in many countries.[33]

Certain other aspects of the Bretton Woods system have also been criticized by representatives of emerging economies. One complaint has been the alleged privileged position of some countries, especially the United States, to issue reserve currency. It has even been suggested that an international reserve currency, independent

[30] For example, the International Fund for Agricultural Development (IFAD).

[31] *A guide to the World Bank* (2003), pp. 62–63; "Multilateral Development Banks", http://web.worldbank.org/ (December 14, 2009); "Inter-American Development Bank", http://www.iadb.org/ (December 14, 2009); "African Development Bank Group", http://www.afdb.org/en/ (December 14, 2009); "Asian Development Bank", http://www.adb.org/ (December 14, 2009); "European Bank for Reconstruction and Development", http://www.ebrd.com/ (December 14, 2009).

[32] e.g. Truman (2007), pp. 54–60; Roubini & Setser (2007), pp. 334–335.

[33] e.g. Li (2007), p. 41.

Table 1. Distribution of voting power in the IMF prior to and as the result of the Quota and Voice Reform, 2006–2008.

	Pre–1st round per cent of total	Post–2nd round per cent of total
24 Advanced Countries*)	60.1	57.4
among them:		
• North America	20.0	19.3
• United States	17.0	16.7
• Japan	6.1	6.2
• Western Europe	32.1	30.2
• EU–15	29.7	27.9
• Germany	6.0	5.8
• France	4.9	4.3
• United Kingdom	4.9	4.3
Commonwealth of Independent States (CIS)	4.3	4.0
among them:		
• Russian Federation	2.7	2.4
Eastern Europe, except CIS countries	3.4	3.5
Asia and Pacific, except Japan, Australia and New Zealand	17.6	19.8
among them:		
• China	2.9	3.8
• India	1.9	2.3
• Korea	0.8	1.4
Latin America and the Caribbean	7.7	8.2
among them:		
• Brazil	1.4	1.7
• Mexico	1.2	1.5
• Venezuela	1.2	1.1
• Argentina	1.0	0.9
Australia and New Zealand	1.9	1.7
Africa	6.9	7.1
Total	100.0	100.0

*) Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, San Marino, Spain, Sweden, Switzerland, United Kingdom, United States

Source: "Reform of Quota and Voice in the International Monetary Fund – Report of the Executive Board to the Board of Governors", March 28, 2008 (http://www.imf.org/external/np/pp/eng/2008/032108.pdf)

of national states, should be created. Moreover, the funding of the World Bank has been considered inadequate with regard to the needs of the developing countries.[34]

The decisions of the IMF from 2006 onwards respond to the reform demands.[35] In 2006 the IMF carried out an *ad hoc* – as distinct from the general reviews at five-year intervals – increase in quotas "to reflect important changes in the weight and role of countries in the world economy". The quotas for China, Korea, Mexico and Turkey, which had been most clearly under-represented, were increased; further reforms were postponed for the next two years.[36] A large package of governance reform was approved in Spring 2008. Apart from quotas reflecting the actual economic weight of each of the members, the reform aimed to enhance the participation and voting power of the poor countries. A new, simpler and more transparent quota formula was approved: the GDP accounts for 50 per cent, while the other variables are related to foreign transactions. The poor countries' voting power was increased by tripling the basic votes. A couple of other stipulations further reinforced the position of the emerging and developing economies. It was emphasized that in the future the five-year reviews would reflect developments in the weight of member countries' economies.[37] These decisions were made before the financial crisis became apparent some months later. They have not yet (June 2010) entered into force.

[34] e.g. Li (2007), pp. 39–40.

[35] e.g. Truman (2007), p. 58.

[36] IMF, Annual Report 2006, pp. 99–100; IMF, Annual Report 2007, pp. 54–55.

[37] 60 per cent of the GDP-related variable is measured through exchange rates and 40 per cent through purchasing power parities. Openness (current payments and receipts), variability (of current receipts and net capital flows) and reserves are weighted 30, 15 and 5 per cent, respectively. Some advanced industrial countries, under-represented under the new formula, agreed to forgo part of the quota increases to which they would have been entitled; an additional quota increase was given to emerging and developing economies with a quota share below their share of GDP measured by purchasing power parity; additional Alternate Executive Directors should be appointed to benefit African countries. IMF, Annual Report 2008, pp. 58–61; "Reform of Quota and Voice in the International Monetary Fund – Report of the Executive Board to the Board of Governors", March 28, 2008, http://www.imf.org/external/np/pp/eng/2008/032108.pdf (January 4, 2010).

The Quota and Voice Reform did not bring about dramatic changes but rather it indicates the gradual change that is expected to take place through the future five-year reviews. The share of 24 advanced industrial countries was, prior to the reform, about 60 per cent of the total voting power but sank to 57 per cent. The United States will continue to be the most influential individual state with a share of about 17 per cent, still retaining its stipulated minority for major decisions. Other countries with a relatively large share have been, notably, Japan, Germany, France and the United Kingdom. The share of the EU-15 sank from 30 to 28 per cent. The shares of Asia, Latin America and Africa rose correspondingly. The main beneficiaries were China, India, Korea, Brazil and Mexico. However, for example, Japan "weighs" slightly more than China and India together, and Germany, France and the UK, each, "weigh" more than China. (Table 1). Obviously, the decision-makers of emerging economies are not very anxious to adopt in practice the offered more prominent role within the Bretton Woods organizations. For increased influence, they should subscribe (i.e. pay money) to increased quotas in the IMF and additional shares in the IBRD, which the surplus countries do not need for their own purposes and the indebted countries can hardly afford.

A comparable reform has been going on within the World Bank Group. During 2008–2010 a reform was carried out which augmented the voting power share of the developing and transition countries from 42.6 to 47.19 per cent. The capital of the World Bank was increased by US$86 billion. Decision-making within the World Bank Group will remain predominantly on the basis of shares ownership, thus the developing and emerging countries have to subscribe to their new shares. For the time being, the ultimate goal for the distribution of voting power is reaching parity between the advanced and the developing and emerging countries during the following years.[38]

[38] "World Bank Reform"; "Press Release No: 2010/092/EXC" (January 5, 2010); Development Committee, "Enhancing Voice and Participation of Developing and Transition Countries in the World Bank Group: update and proposals for discussion", September 29, 2009 (June 18, 2010); "Press Release No: 2010/363/EXT", http://www.worldbank.org/ (June 18, 2010).

Other UN organizations

In the immediate aftermath of World War II, the United Nations Economic and Social Council (ECOSOC), established in 1945, was largely expected to play a leading role in the world economic and social development. Under the auspices of ECOSOC, among other things, regional economic commissions were established[39] but in the circumstances of the Cold War the political significance of these UN organizations became negligible. Some UN special organizations, however, have played an important role. The most remarkable among them appears to be the International Labour Organization (ILO), established already in 1919, originally under the auspices of the League of Nations. The ILO strives to establish world-wide norms for the social conditions of employees. Of importance have also been the United Nations Food and Agriculture Organization (FAO) and the World Health Organization (WHO), established in 1945 and 1948, respectively.

Bank for International Settlements (BIS)

The oldest still functioning international economic institution dates back to the interwar period. The Bank for International Settlements (BIS), located in Basel, Switzerland, was established in 1930 by the central banks of the UK, France, Italy, Belgium and Germany, three large US banks and 14 Japanese banks and was soon joined by all European central banks, except that of the Soviet Union. The consortium of countries forming the Board of Directors consolidated in the early 1930s as follows: the UK, France, Italy, Belgium, Germany, Japan, the United States, Sweden, Switzerland, and the Netherlands. The Federal Reserve System refrained from participating and the US was represented by private banks. Thus, the BIS was from the onset primarily a West European arrangement.[40] In the post-World War II era the BIS was largely eclipsed by the IMF. It also shrank to a purely West European arrangement for a long time. The US Government regarded the BIS as a rival to the IMF. The US private banks withdrew from the Board of Directors. Japan, in fact, was expelled. The central

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[39] The United Nations economic commissions for Europe (ECE) and for Asia and the Far East (ECAFE) in 1947, for Latin America (ECLA) in 1948 and for Africa (ECA) in 1958.

[40] Tew (1988), pp. 120–121; Baker (2002), pp. 5–8; BIS, Annual Report 1930/31, pp. 10–11; (…) 1931/32, p. 34.

banks of Japan and Canada joined the BIS in 1970. It was, however, not until the 1990s that the BIS became a genuinely global institution. In 1994, at last, the Federal Reserve occupied its two seats on the Board of Directors, which had been reserved for it from 1930. In the 1990s a large number of central banks all over the world joined the Bank. For example, the Central Bank of the Russian Federation and the People's Bank of China joined in 1996.[41]

The original assignment of the BIS was to arrange the war reparations imposed on Germany by the Treaty of Versailles. When the possibilities to extract war reparations from Germany soon faded away, the BIS oriented itself to organize cooperation among central banks in other forms.[42] After World War II, the Bank found new terms of reference to complement the functions of the IMF and other international organizations. It had a central role in organizing West European monetary cooperation until the mid-1990s. The BIS has also arranged stabilization credits among member central banks, thus enabling the West European industrial countries to avoid IMF financing with its humiliating conditionality. It has carried out research and consulting activities and compiled statistics. The BIS has hosted the Basel Committee on Banking Supervision (see pp. 34–36) and the Financial Stability Forum (FSF) / Financial Stability Board (FSB) (see p. 37), which have played a critical role in the crisis policies from 2008 (see pp. 103–104).[43]

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[41] Baker (2002), pp. 20–24; BIS, Annual Report 1952/53, pp. 228–229 (Japan); BIS, Annual Reports from 1992/93 onwards (new members).

[42] Tew (1988), pp. 120–121; Baker (2002), pp. 4–5, 8.

[43] In 1950–58, the BIS acted as agent for the European Payments Union (EPU) in the framework of the Organization for European Economic Cooperation (OEEC), implementing the West European multilateral clearing. From 1954 up to the 1980s, it acted as depositary for the loans of the European Coal and Steel Community (ECSC). From 1959, when the West European countries moved to convertibility of their currencies vis-à-vis the dollar, until 1972, the BIS acted as agent for the European Monetary Agreement (EMA) in the framework of the OEEC and the OECD and, thereafter, since the collapse of the Bretton Woods system until the emergence of the euro, for currency cooperation among the EC central banks. Tew (1988), pp. 121–124; Baker (2002), pp. 71–89, 155–166, 185–195; BIS, Annual Reports, 1953/54 to 1994/95.

General Agreement on Tariffs and Trade (GATT) and World Trade Organization (WTO)

As referred to above, the architects of the post-World War II international economic order endeavoured to expand world trade as a means to foster economic growth. An International Trade Organization (ITO) was one of the discussion topics of the Bretton Woods conference but its materialization failed because of opposition from the conservative majority of the US Congress.[44] In anticipation of failure, the project was reduced to the General Agreement on Tariffs and Trade (GATT), signed in 1947. Within GATT, the Contracting Parties made mutual trade concessions which, according to the principle of Most-Favoured-Nation (MFN) treatment, were generalized to apply to all Contracting Parties (if not expressly denied with regard to some of them). The Kennedy (1964–1967), Tokyo (1973–1979) and Uruguay (1987–1993) rounds of negotiations, together, reduced import duties on manufactured goods to about one fourth of the level of the early 1960s. Originally, GATT dealt with trade in manufactured goods, mainly tariffs and tariffs-related issues, but gradually trade liberalization was extended to non-manufacturing industries and to non-tariff obstacles to trade.[45]

The World Trade Organization (WTO), from the beginning of 1995, replaced what thus far had been known as the CONTRACTING PARTIES (written in this way), i.e. the Contracting Parties to GATT acting jointly. The WTO brought, for example, a more efficient settlement of disputes. The Doha round of trade liberalization has been under way since 2001. The near future will show whether the governments can reach an agreement.

The United Nations Conference on Trade and Development (UNCTAD) was established in 1964 to deal with the developing countries' problems with regard to international trade. As a result, the advanced countries have granted a number of unilateral trade concessions to the developing countries.

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[44] Diebold (1952).

[45] On the history of GATT, Curzon (1965); Kock (1969); Senti (1986).

Some Communist-ruled countries belonged to the IMF, the World Bank and GATT already during the Cold War.[46] The collapse of Communism in Eastern Europe in 1989–1991 finally brought about a general movement to join these organizations. By 1992 most of the East European countries, including Russia and the other former Soviet republics, had joint the IMF and the World Bank. During the 1990s and the early 2000s most of these countries joined the WTO. China joined the WTO in 2001. One can say that in the 1990s and early 2000s, by and large, the universalist solutions of the late 1940s finally became genuinely universal. The most important exception is Russia which has not yet joined the WTO.

Regional economic integration has reduced obstacles to trade even more efficiently than the global arrangements. Most impressive has been the economic community of the European Communities (EC) / European Union (EU) complemented by the European Economic Area (EEA). The North American Free Trade Agreement (NAFTA), the Association of Southeast Asian Nations (ASEAN) and other arrangements within the East and South-East Asian space, the South American cooperation organization MERCOSUR, as well as arrangements within the Commonwealth of Independent States (CIS) among most of the former Soviet republics have fostered regional economic integration.

Groups of leading states

Group of Ten (G-10)

From the 1960s, cooperation among leading states began to replace the universalist organizations when determining the guidelines of international financial management. The first of such consortiums was the Group of Ten (G-10). The G-10 consisted of eleven leading Western industrial countries: those eight countries which were

[46] China was an original member of the IMF and the World Bank. China and Czechoslovakia were original Contracting Parties to GATT but China (Taiwan) withdrew in 1950, Kock (1969), p. 65; during the Cold War the Czeckoslovakian membership was to a large extent a formality. Romania, Hungary and Poland joined the IMF and the World Bank in 1972, 1982 and 1986, respectively. Yugoslavia, Poland, Romania and Hungary joined GATT in 1966, 1967, 1971 and 1973, respectively.

represented on the Board of Directors of the Bank for International Settlements (BIS), namely, the United Kingdom, France, the Federal Republic of Germany, Italy, Belgium, the Netherlands, Sweden and Switzerland, augmented with the United States, Canada and Japan. From 1963 onwards the finance ministers and central bank governors of the G-10 held regular meetings to organize rescue operations to defend the fixed exchange rates of the Bretton Woods system. The G-10 actually usurped the role of the Board of Executive Directors of the IMF. The G-10 has been closely connected with the BIS.[47]

The most conspicuous event in the history of the G-10 was the Smithsonian meeting, held in December 1971 at the Smithsonian Institution in Washington. The agreement which was reached there terminated the dollar-gold convertibility that had been the basis of the post-war international monetary system. New exchange rates were defined as "central rates" to the dollar. The US dollar was, in fact, depreciated through appreciation of the German Mark and the Japanese yen.[48] The new system, however, lasted only less than two years until it was replaced by floating (for the EC, joint floating or "currency snake" which eventually led to the European Monetary System and subsequently to the Euro) and currency basket-based exchange rates. An amendment to the IMF Agreement, approved in 1976, recorded the *fait accompli*.[49]

The Basel Committee on Banking Supervision (BCBS) was established by the G-10 central bank governors in 1974 to prepare recommendations for banking standards. Until 2009 it consisted of representatives of 13 countries, namely the 11 G-10 countries, the United Kingdom, France, the Federal Republic of Germany, Italy, Belgium, the Netherlands, Sweden, Switzerland, the United States, Canada and Japan, plus Luxembourg and Spain. A permanent secretariat is provided by the BIS.[50]

In 1988, the BCBS issued a capital measurement system, known as the Basel Accord. The revised framework, known as Basel II,

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[47] Tew (1988), pp. 121, 128–129; Baker (2002), pp. 24–25.

[48] Tew (1988), pp. 154–156.

[49] Tew (1988), pp. 157–164, 174–180.

[50] "History of the Basel Committee and its Membership"; "Expansion of membership announced by the Basel Committee", 13 March 2009, http://www.bis.org/bcbs/history.htm (August 27, 2010).

was issued in 2004.[51] The Basel standards have been adopted by substantially all countries.

The Basel Framework applies to internationally active banks. It aims to protect the international financial system against major debacles. The recommendations aim to secure the capital adequacy of commercial banks by determining capital requirements commensurable to the risks involved. The solvency stipulations also aim to prevent excessive credit expansion, disproportionate to real economic growth.

The First Pillar of the Framework defines, firstly, the minimum capital requirements for credit risks. With regard to credit risks, the principle is that the capital ratio, i.e. the proportion of eligible regulatory capital to risk-weighted assets, must be at least 8 per cent. Thus, a "good" loan portfolio can be even considerably larger than 12.5 times the eligible regulatory capital, while high-risk assets require higher total capital ratios than the theoretical 8 per cent. The Framework divides the eligible regulatory capital into two tiers according to the capability of different categories of capital to absorb credit losses. Tier 1, called Core Capital, consists of equity capital and disclosed profits. Tier 1 must cover at least half of the required capital base. Tier 2, called Supplementary Capital, consists of credible other reserves, hybrid debt-capital instruments, and, to a limited extent, subordinated term debt instruments with maturity of at least five years, all of which support losses. Tier 2 can cover at the most half of the required capital base.

The First Pillar also contains provisions for market and operational risks. Market risk is related to a financial institution's trading book, i.e. the portfolio of tradeable securities. Market risk arises, for example, from changes in interest rates, exchange rates, stock rates, or changes in the rating of a security issuer. The Committee also specifies a Tier 3, consisting of short-term subordinated debt instruments with maturity of at least two years and available to absorb losses in the event of insolvency, to meet a part of capital requirement for market

[51] *International Convergence of Capital Measurement and Capital Standards* (2006) is a compilation of the 1988 and 2004 accords, complemented with the 1996 *Amendment to the capital accord to incorporate market risks* and the 2005 paper *The Application of Basel II to Trading Activities and the Treatment of Double Default Effects*.

risks. Operational risk is related to failures in internal management and losses arising from external events.

The Second Pillar deals with bank supervision. The basic principle is transparency and accountability. The Committee refers, e.g. to stress tests as a method to ensure that banks have sufficient capital to meet the Pillar I requirements. The Third Pillar, market discipline, deals with accounting and disclosure standards.[52]

Group of Seven (G-7) / Group of Eight (G-8)

Soon after the Smithsonian meeting, the G-10 was virtually eclipsed by what was originally called the Group of Five (G-5). The meetings of the finance ministers of the United States, France, the United Kingdom, the Federal Republic of Germany and Japan sought solutions to the actual currency-stability problems after the first Oil Crisis of 1973, in the circumstances of "managed floating", thus usurping the former role of the G-10. The cooperation was institutionalized in 1975 as summit meetings when the leaders agreed to annual meetings organized under a rotating presidency. With the addition of Italy, the consortium was renamed the Group of Six (G-6). When Canada joined in 1976, it became the Group of Seven (G-7). In addition to the seven countries, the EC/EU has been represented in the meetings. Much later, from 1998, the Russian Federation has participated in the cooperation; the arrangement was renamed the Group of Eight (G-8). The Group has convened on summit and finance ministers' and central bank governors' levels, the former arranged once and the latter several times a year, sometimes also in other ministerial compositions.

Originally, exchange rate policies and related issues were the main concern of the G-7. The Plaza Accord of 1985, albeit carried out among the original G-5, was a repetition of the Smithsonian deal: the US dollar was again depreciated through appreciation of the German Mark and the Japanese yen.[53]. With time, the G-7 agenda was enlarged to cover virtually all problems with relevance

[52] Lybeck (2009), pp. 144–156; *International Convergence of Capital Measurement and Capital Standards* (2006).

[53] Tew (1988), pp. 229–231; "Announcement the Ministers of Finance and Central Bank Governors of France, Germany, Japan, the United Kingdom, and the United States (Plaza Accord), September 22, 1985", http://www.g8.utoronto.ca/finance/ (March 5, 2010).

to international economic relations. For example, the G-7 Summit of 1989 established an inter-governmental body, the Financial Action Task Force on Money Laundering (FATF) to combat money laundering and terrorist financing[54].[55]

The Financial Stability Forum (FSF) was established by the G-7 finance ministers and central bank governors in 1999 to promote cooperation among national and international financial institutions and supervisory bodies. Originally the FSF consisted of representatives of finance ministries, central banks and leading regulatory bodies of the G-7 countries, as well as representatives of the IFIs and international standard-setting bodies. Already the same year Hong Kong, Singapore, Australia, and the Netherlands were invited to join. Switzerland joined in 2007.[56] The secretariat of the FSF has been hosted by the BIS. During the financial crisis of 2008–2009 the FSF was to play a central role in designing the new financial architecture. In 2009 the FSF was enlarged to the present Financial Stability Board (FSB) (see p. 118).[57]

Group of Twenty (G-20)

The Group of Twenty (G-20) as a cooperation forum for finance ministers and central bank governors was established in 1999. The two important background factors were, firstly, the growing concern over financial stability as a result of the Asian financial crisis (see pp. 49–50), and, secondly, the notion that countries of emerging economies were not adequately represented in global economic discussion and governance. The G-20 aimed to be “a new mechanism for informal dialogue in the framework of the Bretton Woods institutional system”

[54] “About the FATF”, http://www.fatf-gafi.org (April 11, 2010).

[55] Tew (1988), pp. 172–173; “What is the G8?”, http://www.g7.utoronto.ca/ (December 18, 2009); “G7/G8, G20”, http://ec.europa.eu/economy_finance/international/forums/g7_g8_g20/index_en.htm (January 14, 2010).

[56] “First meeting of the Financial Stability Forum”, 6 April 1999; “Broadening representation in the Financial Stability Forum”, 21 June 1999; “Switzerland to join the Financial Stability Forum as a member”, 9 January 2007, http://www.bis.org/ (August 26, 2010).

[57] “History [of Financial Stability Board]”, http://www.financialstabilityboard.org/ (January 4, 2010).

between industrial countries and emerging economies on issues related to global economic stability.[58]

The G-20 can be regarded as highly representative of the international community, since it covers about 90 per cent of global GDP, 80 per cent of world trade (including intra-EU trade) and two-thirds of world population. The G-20 consists of representatives of the 19 largest national economies and the EU. The member countries are, first, the G-8 countries, the United States, France, the UK, Germany, Japan, Italy, Canada and Russia; in addition, Australia, the emerging Latin American countries, Brazil, Mexico and Argentina, the emerging Asian countries, China, India, Indonesia, South Korea, Turkey, and the oil giant Saudi Arabia, and South Africa. The EU has been represented by the European Central Bank and, at summit level, first by the rotating Council presidency and from the Lisbon Treaty onwards, by the President of the European Council. Representatives of the IMF and the World Bank are present in the meetings, which ties the G-20 closely to these organizations. The G-20, for example, contributed decisively to the IMF governance reform in 2006–2008[59].

The G-20 has no permanent secretariat but the chair rotates among the members. In 2008 the chair was in Brazil, in 2009 in the United Kingdom, in 2010 it is in the Republic of Korea, and in 2011 it will be in France. The incumbent chair establishes a temporary secretariat for the duration of its term. To ensure continuity across host years, the former, present and following chairs form a Troika to consult on management questions.[60]

For almost the first decade the G-20 was eclipsed by the G-7/G-8. Until 2008, the G-20 convened in the composition of finance ministers and central bank governors once a year, while the G-7/G-8 convened several times a year in different compositions[61]. The financial crisis of 2008–2009 was, however, of a magnitude which exceeded the

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[58] "Meeting of G-20 Finance Ministers and Central Bank Governors, Berlin, December 15–16, 1999. Communiqué" [2].

[59] Truman (2007), pp. 58.

[60] "What is the G-20", http://www.g20.org/ (December 18, 2009); "G7/G8, G20", http://ec.europa.eu/economy_finance/international/forums/g7_g8_g20/index_en.htm (January 14, 2010).

[61] See G-7/G-8 materials from 1975 onwards, http://www.g7.utoronto.ca/.

management capacity of the leading advanced countries.[62] From Autumn 2008 onwards, the G-20 developed unprecedented activity to tackle the assaulting threats to the world economy. In this situation, the G-20 emerged as the principal forum on which the international community solves global problems, actually superseding the G-7/G-8. The crisis management efforts from Autumn 2008 on also introduced the practice of G-20 summit meetings. The Pittsburgh Summit, September 2009, "designated the G-20 to be the premier forum for [their] international economic cooperation"[63]. The G-7/G-8 is still functioning but eclipsed by the G-20 in questions of the world economy; it seems to focus on security-policy questions such as terrorism, the Iranian nuclear programme etc., even though questions of economic stability are also dealt with.[64] The G-10 appears not to have been active after 2007.

Once introduced as a forum of crisis politics, the G-20 summits were consolidated as a permanent practice. After having convened on summit level once in 2008 and twice in 2009 and 2010, the Pittsburgh Summit, September 2009, envisaged a summit meeting once a year from 2011 onwards.[65]

The role of the G-20 as the leading group of countries to consider and resolve global problems is based on cooperation with the key international organizations, notably the IMF, the World Bank and the WTO. The leading standard-setting bodies, the Basel Committee on Banking Supervision and the Financial Stability Board (until Spring 2009 called the Financial Stability Forum), originally established by the G-10 and the G-7, respectively, are closely linked to the G-20. (See pp. 103-105). It is, however, noteworthy that the relationship between the G-20 and the OECD has remained shallow - mainly related to tax-information exchange - obviously because of the nature of the OECD as an organization of the advanced countries. Surely, the significance of the G-20 will fade to some extent once the present distress is overcome.

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[62] Cf. Stiglitz (2010), pp. 211-212.

[63] "Leaders' Statement. The Pittsburgh Summit, September 24-25, 2009" [50].

[64] Cf. G-7/G-8 materials from 2008 onwards, http://www.g8.utoronto.ca/.

[65] "Leaders' Statement: The Pittsburgh Summit, September 24-25, 2009" [50].

3. Growth and Fluctuations in the World Economy

Vigorous economic growth and its regional distribution

The era of industrialism is characterized by continuous economic growth. As a rule, international trade has grown faster than production, thus acting as a vehicle of economic growth. After World War II the growth accelerated. Efforts to promote both world-wide and regional trade liberalization in the post-World War II era have contributed to the rapid economic growth during the past decades.

Economic growth takes place through structural change. As stated in the Introduction, advanced economies develop new products and production processes, while the less advanced countries adopt mature industries. Since it is cheaper to replicate than to create, in favourable conditions the international economy is characterized by a process of convergence, in which the less advanced countries catch up with the more advanced ones. Approximately from the 1970s onwards, the leading industrial countries underwent a development called de-industrialization. Information technology (IT) became the new growing industry. Manufacturing processes were automatized and labour-intensive bulk production was relocated to low-wage countries. A new era of globalization was introduced from the 1980s onwards by drastically increasing flows of foreign direct investment (FDI) and the development of communication.

Growth was exceptionally fast during what Angus Maddison calls the Golden Age, from the end of World War II until the first Oil Crisis, 1973. In 1950–73, the world economy grew by an annual average of 4.9 per cent. There seems to have been no drastic differences among regions in the rates of total growth, even though growth rates higher than the world average can be distinguished in Asia and Latin America. Notably, the high growth rates of Japan are distinctive. (Table 2.)[66]

After the first Oil Crisis, 1973–1974, economic growth slowed down but, nonetheless, continued at relatively high levels. During 1973–2007, the average annual growth in world GDP was 3 per cent.

[66] Maddison (2006), pp. 125–167.

Table 2. Average annual growth of real GDP, 1950–2009, per cent.

	1950–73	1973–90	1990–07	1973–07	2008	2009
World	4.9	3.0	2.9	3.0	3.0	–0.6
23 Advanced countries*)	4.8	2.8	2.3	2.6	0.3	–3.4
North America	4.0	3.0	2.9	2.9	0.4	–2.5
among them:						
• United States	3.9	2.9	2.9	2.9	0.4	–2.4
Western Europe	4.8	2.4	2.1	2.3	0.6	–4.1
among them:						
• EU–15	4.8	2.5	2.1	2.3	0.5	–4.2
• Finland	4.9	2.9	2.4	2.7	1.2	–7.8
Soviet Union/ Commonwealth of Independent States (CIS)	4.8	4.6	0.3	..	5.5	–6.6
among them:						
• Russia	..	..	0.3	..	5.6	–7.9
Eastern Europe, except CIS and Baltic countries	4.9	2.5	3.6	3.1	4.5	–2.8
Baltic countries	..	..	1.5	..	–0.9	–15.7
Asia and Pacific**)	6.1	4.6	4.7	4.7	4.9	2.8
among them:						
• Japan	9.3	3.7	1.4	2.5	–1.2	–5.2
• China (incl. Hong Kong)	5.1	7.9	9.7	8.8	9.3	8.3
• Korea	8.1	7.9	5.5	6.7	2.3	0.2
• India	3.5	5.0	6.4	5.7	7.3	5.7
Latin America and the Caribbean	5.4	3.0	3.3	3.1	4.3	–1.8
among them:						
• Brazil	6.8	3.8	2.8	3.3	5.1	–0.2
• Mexico	6.4	3.7	3.1	3.4	1.5	–6.5
• Argentina	3.8	0.3	4.1	2.1	6.8	0.9
Australia and New Zealand	4.4	2.6	3.5	3.1	2.1	1.0
Africa	4.4	2.9	3.8	3.3	5.4	2.7

*) Australia, Austria, Belgium, Canada, Denmark, Greece, Finland, France, Germany, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, United States.

**) Except Australia and New Zealand; except the Asian CIS countries.

Sources: World Economy: Historical Statistics; UN National Accounts Statistics; WEO Database, April 2010.

The economies of the advanced countries grew relatively steadily, even though growth rates were slightly below the world average. The relatively impressive growth rates of the Soviet Union and East European People's Democracies until the collapse of Communism are retrospective, and may be based on Soviet-time manipulated or inadequate data. (In contrast to the United Nations figures, Professor Maddison's historical statistics give the Soviet Union and the East European People's Democracies average annual growth rates of only 1.6 and 1.1 per cent, respectively, during 1973–1990.[67]) From the 1970s and 1980s onwards many thus-far developing countries adopted an economic policy of export-led growth, based on the comparative advantage of cheap labour. The most vigorous growth has been witnessed in Asia; during 1973–2007 an annual average of more than 4 per cent. In the 1980s, the Four Tigers, i.e. (South) Korea, Taiwan, Hong Kong and Singapore, emerged as Newly Industrialized Countries (NICs), imitating the economic miracle of Japan of the 1950s and 1960s. Nowadays, they already belong to the advanced, high-income countries. From the 1980s onwards China joined the endeavour of export-led growth. Since then, economic growth has been most vigorous in China, about 10 per cent being a usual annual figure. The second largest Asian country, India, has recently also emerged as the second fastest growing economy. Also Indonesia and Turkey have been distinguished as considerable emerging economies. In Latin America, growth rates have equalled or slightly surpassed those of the old industrial countries but have not been as impressive as in Asia. Especially the large countries, Brazil, Mexico and Argentina, have been noticed as important emerging economies. (Table 2.)

The United States emerged from World War II as the overwhelmingly richest nation, even strengthened economically, while most other nations were exhausted by the war. The economic basis of US supremacy had developed gradually from the 19th century onwards, but only as a result of World War II did the US presidential administration awaken to the consciousness of being the leading world power. The United States also became the indisputable centre of the world economy. After World War II, the US was also the only

[67] World Economy: Historical Statistics; Maddison (2006), spec. Table A1-e.

state equipped with adequate economic resources to maintain a world-wide foreign-policy agenda. The US government promoted world economic development by grants and credits, except to the Communist-ruled countries to which aid was denied. During the Cold War, the Soviet Union challenged the US supremacy but eventually its resources were exhausted.

In 1970, the earliest year for which world-wide cross-sectional statistical data for international GDP comparisons are available[68], the United States and North America produced a third of world GDP as measured through exchange rates. Western Europe produced a quarter of world GDP. According to retrospective[69] UN estimates, at the same time the Soviet Union and Eastern Europe together would have produced about a sixth part of world GDP. The share of Asia was also approximately a sixth part. Latin America produced about 6 and Africa less than 3 per cent.

In spite of faster growth in the emerging and developing economies, the Western countries are still the leaders of the world economy. Comparative statistical data of 2007, the last "normal year" thus far, illustrate the situation. The United States was still the overwhelmingly largest national economy with 25 per cent of global GDP in terms of exchange rates and 21 per cent as measured through purchasing power parities (PPPs). The European Union (EU-27) would have been the largest economy, but the heterogeneous Community cannot be paralleled with a national economy. Western Europe and the EU-15 were, by and large, equal with North America. (The apparent increase in the share of Western Europe relative to North America in terms of exchange rates since the early 1970s is due to the long-term depreciation of the dollar since the collapse of the Bretton Woods system.)

Asia is gradually but irrevocably becoming the economically weightiest region. In terms of exchange rates, in 2007 the aggregate share of Asia was still lagging behind North America and Western Europe but, in terms of PPPs, Asia has already bypassed the advanced

[68] The historical growth-studies calculations, spec. Maddison (2006), suit, as indicated by the designation, longitudinal-section analyses.

[69] The Communist-ruled countries accounted material production, i.e. production of goods. Hence, GDP calculations, based on UN standards, for the era of Communist rule are retrospective.

Table 3. Distribution of world GDP by regions and selected countries, by current exchange rates and current purchasing power parities (PPPs), in 1970, 1990, 2007 and 2009, per cent.

	Exchange rates				PPPs		
	1970	1990	2007	2009	1990	2007	2009
North America	33.8	28.5	27.5	26.9	24.8	23.2	22.3
among them:							
• United States	31.2	25.9	24.9	24.6	22.6	21.3	20.5
Western Europe	25.4	33.3	30.0	27.9	24.0	20.6	19.5
among them:							
• EU-15	24.2	31.6	28.4	26.3	22.9	19.7	18.6
Former Soviet bloc and Yugoslavia	15.9	4.6	5.4	5.1	..	7.3	7.1
Commonwealth of Independent States (CIS)	..	3.4	3.0	2.8	..	4.4	4.3
among them:							
• USSR	13.2	6.9	..	..	..	..	..
• Russia	..	2.6	2.3	2.1	..	3.2	3.0
• Other CIS countries	..	0.8	0.7	0.7	..	1.3	1.2
Eastern Europe, except CIS countries	..	1.2	2.3	2.3	..	2.9	2.9
Asia and Pacific	15.2	24.0	26.0	28.8	25.7	35.2	37.2
among them:							
• Japan	6.2	13.6	7.9	8.7	9.0	6.5	6.0
• China (incl. Hong Kong)	2.9	2.2	6.7	8.8	3.9	11.2	13.0
• Korea	0.3	1.2	1.9	1.4	1.3	1.9	2.0
• India	1.9	1.5	2.1	2.1	2.8	4.5	5.1
Latin America and the Caribbean	5.6	5.5	6.9	6.9	8.6	8.5	8.5
among them:							
• Brazil	1.3	2.1	2.4	2.7	3.1	2.8	2.9
• Mexico	1.3	1.3	1.8	1.5	2.4	2.3	2.1
• Argentina	1.0	0.6	0.5	0.5	0.7	0.8	0.8
Australia and New Zealand	1.5	1.6	1.9	1.9	1.4	1.4	1.4
Africa	2.6	2.2	2.3	2.5	3.6	3.8	4.0
Statistical discrepancy	0.0	0.3	0.0	0.0	3.6	0.0	0.0

Sources: UN National Accounts Statistics; WEO Database, April 2010; "Estimates of total and per capita gross domestic product in purchaser's values", *United Nations Statistical Yearbook* 1971.

economies. Japan has been the second largest national economy in terms of exchange rates but the economic development has been sluggish since the early 1990s. At present, China is challenging Japan as the world's second largest economy. In 2007, China (incl. Hong Kong) was already the third largest economy, forming almost 7 per cent of global GDP in terms of exchange rates. However, in terms of PPPs, China (incl. Hong Kong) surpassed Japan already in 2001, forming, in 2007, over 11 per cent of world GDP on this basis.

The countries of the former Soviet Union and the East European transitional economies underwent in the 1990s severe adjustment problems with an economic decline, but in the 2000s, until the economic crisis, their growth performance was impressive. In 2007, their combined share of world GDP was slightly over 5 per cent in terms of exchange rates and slightly over 7 per cent in terms of PPPs.

The moderate share of Africa has not risen during the past decades. Still in 2007, almost a billion Africans shared 2.3 or 3.8 per cent of world GDP in terms of exchange rates vs PPPs, respectively. (Table 3.)

Growth of total GDP affects the relative economic weights of different countries within the world economy, whereas economic welfare is determined in the first place by production per head. In terms of GDP per capita, the Golden Age was favourable for Europe, especially Western Europe, and Japan. In many developing countries, population growth largely eliminated the welfare effects of growth. In Africa and in many Asian countries development was sluggish and even regressive in this respect. In the Western industrial countries the growth of GDP per capita continued at a steady pace even during the era of slower growth after the oil crises, above the world average. However, Asia has surpassed the West also in this respect. Latin American figures were for a long time below those of the advanced countries but have, by and large, equalled them from the 1990s onwards. In spite of the poor economic performance of the countries of the former Soviet Union and East European former People's Democracies in the 1990s, in most of them nowadays the income levels per capita clearly bypass those of China or Asia as a whole, or of Latin America. Africa is still clearly the poorest continent. Until quite recently, population growth absorbed most of the welfare effect of economic growth. The figures

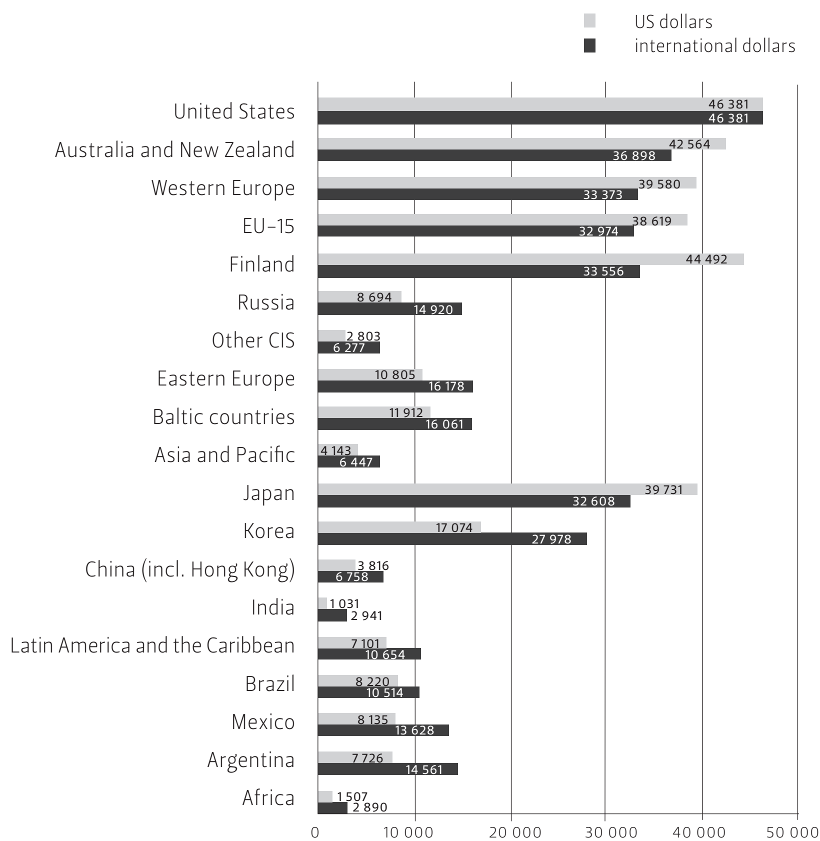
Table 4. Average annual growth of real GDP per capita, 1950–2009, per cent.

	1950–73	1973–90	1990–07	1973–07	2008	2009
World	2.9	1.2	1.5	1.4	(1.0)	
23 Advanced countries*)	3.7	2.2	1.7	1.9	−0.3	−3.9
North America	2.5	1.9	1.7	1.8	−0.5	−3.3
among them:						
• United States	2.5	1.9	1.7	1.8	−0.5	−3.3
Western Europe	4.1	2.1	1.7	1.9	−0.7	−2.2
among them:						
• EU–15	4.1	2.1	1.7	1.9	−0.1	−4.6
• Finland	4.3	2.6	2.1	2.3	0.7	−8.2
Soviet Union/ Commonwealth of Independent States (CIS)	3.3	3.8	0.3	..	5.4	−6.7
among them:						
• Russia	..	..	0.6	..	5.8	−0.2
Eastern Europe, except CIS and Baltic countries	3.8	2.0	3.7	2.9	4.3	−2.8
Baltic countries	..	1.1	2.3	..	−0.5	−15.2
Asia and Pacific**)	3.9	2.7	3.4	3.0	3.7	1.7
among them:						
• Japan	8.1	3.0	1.2	2.1	−1.1	−5.1
• China (incl. Hong Kong)	2.9	6.2	8.7	7.5	8.7	7.8
• Korea	5.8	6.4	4.8	5.6	2.0	−0.1
• India	1.4	2.6	4.5	3.6	5.8	4.2
Latin America and the Caribbean	2.6	0.8	1.7	1.3	3.0	−3.0
among them:						
• Brazil	3.7	1.5	1.4	1.5	4.0	−1.2
• Mexico	3.2	1.4	1.5	1.5	0.6	−7.3
• Argentina	2.1	−1.2	2.9	0.8	5.7	−0.1
Australia and New Zealand	2.3	1.3	2.2	1.8	0.3	−2.6
Africa	2.0	0.0	1.3	0.7	3.0	0.3

*) Australia, Austria, Belgium, Canada, Denmark, Greece, Finland, France, Germany, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, United States.

**) Except Australia and New Zealand; except the Asian CIS countries.

Sources: World Economy: Historical Statistics; UN National Accounts Statistics; WEO Database April 2010.



The "international dollar" is a measurement unit, an amount of national currency the purchasing power of which equals that of a US dollar in the United States.
Source: WEO Database, April 2010.

Figure 1. Gross Domestic Product per capita in certain countries and groups of countries, 2009, in US dollars and International dollars.

for the 2000s, however, indicate that even Africa may be joining the general stream of increasing economic prosperity. (Table 4, Figure 1.)

The GDP of different countries is composed in different ways. Even at the stage, in a couple of decades, when Chinese and/or Indian GDP is expected to surpass the American one, the United States most probably still will be in the leading position within the world economy, since it is a high-tech country and most probably the dollar

will still be the most important reserve currency, albeit not as central as it still is today.

The return of financial crises

As stated in the Introduction, for many decades after World War II the word economy developed relatively smoothly. It did not experience a crash like the Great Depression of 1929–1933. From the 1980s onwards, however, the global market economy with liberalization of capital movements also involves the return of financial crises.

There have been a number of regional financial crises during the past couple of decades up to the present crisis. The first severe setback was the US Thrift Banks Crisis in the 1980s. The United States also underwent a temporary boom and bust of asset prices in 1987. In the wake of deregulation of financial markets during the latter half of the 1980s, in Japan and in the Nordic countries, a price bubble in stocks and real estates emerged, leading to a financial crash in the early 1990s. In the 1990s there was the so-called “dot-com boom”. The Mexican banking crisis occurred in 1994–1995. In the late 1990s, there were the Asian and the Russian financial crises. Major recent financial crises were those in Turkey and Argentina in the early 2000s. These crises, however, did not escalate world-wide.[70]

The US Thrift Banks Crisis (savings and loans banks) lasted from the early 1980s up to the 1990s. The main cause was maturity mismatch in circumstances of banking deregulation. The thrift banks granted long-term mortgage loans while funds were raised in the short term. Rising interest rates exposed many banks to an unsustainable situation.[71] The Thrift Banks Crisis was, however, rather a structural grievance and not exactly a matter of cyclical fluctuations.

In the late 1980s, Japan experienced a price bubble in stocks and real estates, financed by generous bank loans for speculative investments. Prices began to plummet from 1991. There was no drastic slump in production but, instead, a long-time, apparently permanent

[70] Kindleberger & Aliber (2005), pp. 1–9, 265; Krugman (2008), pp. 31–52; Lybeck (2009), pp. 168–208 Hoelscher (2003), Appendices I–II.

[71] Lybeck (2009), pp. 188–191.

recession. Desperate efforts to foster economic growth through debt stimulus have led to the highest public debt in the world.[72]

The Nordic financial crisis was analogous to and took place simultaneously with the Japanese one. In the late 1980s, Norway, Sweden and Finland experienced an economic boom, characterized by a price bubble in stocks and real estates. The crisis was preceded and the boom financed by vigorous credit expansion. Remarkable credit losses began to emerge first in Norway in 1987–1988, then in Sweden in 1990, and in Finland in 1991. The crisis and depression were worst in Finland, where the situation was aggravated by the collapse of Soviet trade as a result of the Russian political turmoil. The Finnish GDP plummeted during 1990–1993 by 12 per cent, in real terms back to the level of 1986. From the beginning of 1990 to the beginning of 1993 the slump was even 14 %. Credit losses rose up to 1992. The unemployment rate rose, at the highest, to 21 per cent in January 1994. The Nordic banking systems were rescued by state intervention, by recapitalization of banks through budgetary means and governmental guarantees for creditors; in Finland and Sweden also by absorbing impaired assets into "junk banks". The Finnish bank support, amounting to 14 per cent of the 1992 GDP, was approximately as large as the Swedish and the Norwegian together.[73]

The Mexican monetary crisis of 1994–1995 occurred after large capital inflows during the previous years. The Mexican peso, pegged to the US dollar and with higher domestic price rises than in the US, rapidly lost credibility and became exposed to speculation, with the result of huge capital drains out of the country and drastic devaluation. The situation was, however, soon saved by US financial intervention. Because of international repercussions, the development is also referred to as the Latin American crisis. Especially Argentina was hit similarly though on a smaller scale.[74]

The Asian financial crisis of 1997–1999 resembled the previous Latin American one but on a larger scale. The heart of the South-East Asian business cycle was Thailand, but the developments were similar in Indonesia and Malaysia. The slump of 1997 was preceded

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[72] Krugman (2008), pp. 61–76.

[73] Lybeck (2009), pp. 191–208; Borio & Vale & von Peter (2010), spec. Annexes 1–3; for Finland, see Kiander & Vartia (1998), pp. 77–158.

[74] Kindleberger & Aliber (2005), pp. 234–235; Krugman (2008), pp. 31–52.

by vigorous investments in domestic construction, financed mainly by foreign, yen and dollar-denominated loans. With time, the exchange rates of the local currencies, pegged to the dollar, were not sustainable. The crisis was triggered by Thailand's forced decision in July 1997 to let the baht float, resulting in an abrupt rise in foreign debts in terms of the baht. The crisis immediately spread to Indonesia, Malaysia, South Korea and the Philippines. The situation was saved only by massive support from the International Monetary Fund. (The conditionality of IMF loans gave the people of the region a suitable reason to blame the IMF for the crisis.)[75]

The Russian financial crisis in 1998 was basically a result of the unsuccessful transition from a centrally-panned to a market economy after the collapse of Communism. Production fell and poverty grew continuously from the late 1980s until the late 1990s. The state debt, accumulated over about a decade, was not unreasonably high, about a quarter of what has been estimated as the Russian GDP, but it had grown disproportionate to state revenue. By Summer 1998, interest payments exceeded revenue. To support the post-Communist regime in Russia, the Western countries persuaded the IMF and the World Bank to grant a stabilization loan of US$22.6 billion to Russia. Russia, however, suspended honouring its debts, even though interest payments were soon resumed. One consequence was an abrupt fall in the exchange rate of the rouble in Autumn 1998. The Russian financial crisis also triggered the failure of Long Term Capital Management, a famous US hedge fund that suffered considerable credit losses from Russian state loans.[76]

The Turkish financial crisis in the early 2000s was preceded by chronic macro-economic imbalances: rising public debt, accumulating current-account deficits and high inflation, combined with a banking system that has been characterized as "fragile". The relationship between the banking system and state finance was highly unsustainable. Banks exercised arbitrage by borrowing in foreign currencies at a low interest rate and lending to the state at a high interest rate. Banks were, to a great extent, dependent on interest payments by the state, while the state debt was served through roll-over, i.e. by taking on new debt. The IMF-supported stabilization

[75] Krugman (2008), pp. 77–97; Lybeck (2009), pp. 173–177.

[76] Krugman (2008), pp. 132–138; Lybeck (2009), pp. 181–184.

programme of 1999 could not save the situation. Financial turbulence was triggered in November 2000 when loss of confidence in the Turkish lira led to a rush to foreign currencies with a large drain on exchange reserves. In February 2001, the central bank had to allow the lira to float freely, resulting in complete collapse of the exchange rate. The result was economic depression.[77]

The last major financial crisis prior to the recent one was that in Argentina from late 2001 onwards. The background was, again, a vigorous increase in foreign borrowing after the previous Latin American financial crisis was overcome and investors' confidence had returned. Pegging the peso to the US dollar, when the exchange rate of the latter soared during the same period and Brazil devalued its currency, led to Argentina losing its competitiveness in the Euro Area and in Brazil, its main export markets. The consequences were capital flight, collapse of the exchange rate of the peso, drastic increase in dollar-denominated debts in terms of the peso and economic depression in 2002.[78]

There were still other fluctuations in real-estate and stock prices which in principle could have led to severe economic crises but actually did not. The "Black Monday" in the New York Stock Exchange on October 19, 1987, with repercussions in other countries, marked an end – once again – to a real-estate and stock price boom, but there was no collapse of the real economy.[79] In the 1990s, the world experienced the "dot-com boom", a stock-price boom especially in information-technology branches, based on over-optimistic expectations of the new information technology. Stock prices reached their peak in 2000. They sank drastically during 2000–2003, but the real economy suffered only a slight slow-down of growth.[80]

The financial crises of roughly the last two decades, prior to the recent one, were severe setbacks for the regions concerned. But they did not escalate world-wide. The Latin American and Asian crises of the 1990s were the most severe ones. They did not trigger a general alarm in the financial metropolises, obviously because they took place in the "periphery". Also Western banks which had lent to these

[77] Akyüz & Boratov & (2002), pp. 1–29; Özatay & Sak (2002), pp. 1–26.

[78] Krugman (2008), pp. 97–100.

[79] Kindleberger & Aliber (2005), pp. 26–27, 93–94, 102, 108, 184, 209, 264.

[80] Cf. Krugman (2008), pp. 141–147; Lybeck (2009), pp. 91–99.

countries were rescued, which reinforced confidence in the resilience of the financial system rather than awaked distrust.[81]

The recent financial crisis, which started to unfold in the housing market of the United States in Summer 2007, was the most recent in a series of debacles during the past couple of decades. It emerged as a typical financial crisis but immediately spread to the real economy. From the United States and European perspective it was also the most severe since the Great Depression.

Imbalances of the world economy

The present world economy is shadowed by two kinds of crucial imbalances, in both of which the United States, the leading economy, is deeply involved. Firstly, there is the US balance-of-payments deficit, or, more exactly, deficit on its current account. Secondly, many countries but most fatefully the United States have accumulated a large public debt. In many cases these imbalances are unsustainable. The US imbalances, as will be presented further on, have enabled the rest of the world to accumulate dollar-denominated exchange reserves, but an excessive increase in them can also undermine the dollar's credibility as the leading world currency if the creditors eventually lose their confidence in the United States' capability to serve its debts. The imbalances were obviously not the cause of the recent financial crisis but they were without doubt "a critically important codeterminant" (Obstfeld & Rogoff, 2009) for it. In any case they have formed a constraint to stimulus policies to remedy the economic slump.

Different savings, investment and consumption patterns in different countries form the background for the present disequilibria. The advanced economies are characterized by low and the emerging economies by high savings and investment rates. By definition, investments equal savings in a closed economy and also in the world economy as a whole. The preference of the decision-makers and residents of the poorer countries to save money and the inclination of those in the rich countries to spend it have brought about a situation where investments in the advanced countries exceed domestic savings, while savings in the emerging and developing countries exceed

[81] See Stiglitz (2010), pp. xvi, xix–xx.

Table 5. Balance on current account of OECD countries, 2001–2009, per cent of GDP.

	2001	2002	2003	2004	2005	2006	2007	2008	2009
Australia	−2.0	−3.6	−5.2	−6.0	−5.6	−5.2	−6.1	−4.4	−4.1
Austria	−0.8	2.7	1.7	2.2	2.2	2.8	3.6	3.3	2.3
Belgium	3.4	4.6	4.1	3.5	2.6	2.0	1.6	−2.9	0.5
Canada	2.3	1.7	1.2	2.3	1.9	1.4	1.0	0.5	−2.7
Czech Republic	−5.3	−5.5	−6.2	−5.2	−1.3	−2.4	−3.2	−0.6	−1.0
Denmark	2.6	2.9	3.4	2.3	4.3	3.0	1.5	2.2	4.0
Finland	8.6	8.9	5.2	6.6	3.6	4.6	4.2	3.0	1.3
France	2.0	1.3	0.9	0.6	−0.4	−0.5	−1.0	−2.3	−2.2
Germany	0.0	2.0	1.9	4.6	5.1	6.4	7.7	6.7	5.0
Greece	−7.3	−6.8	−6.5	−5.8	−7.3	−11.3	−14.4	−14.6	−11.2
Hungary	−6.0	−6.9	−7.9	−8.3	−7.2	−7.1	−6.5	−7.1	0.2
Iceland	−4.3	1.5	−4.8	−9.8	−16.1	−24.4	−16.3	−18.5	−3.3
Ireland	−0.6	−1.0	0.0	−0.6	−3.5	−3.6	−5.3	−5.2	−2.9
Italy	−0.1	−0.8	−1.3	−1.0	−1.6	−2.6	−2.4	−3.5	−3.1
Japan	2.2	2.9	3.2	3.7	3.6	3.9	4.9	3.3	2.8
Korea	1.6	0.9	1.8	3.9	1.8	0.6	0.6	−0.5	5.2
Luxembourg	8.8	10.5	8.1	11.9	11.0	10.3	9.7	5.3	5.6
Mexico	−2.6	−2.0	−1.0	−0.7	−0.5	−0.5	−0.8	−1.5	−0.6
Netherlands	2.4	2.5	5.5	7.5	7.3	9.3	8.7	4.8	5.4
New Zealand	−2.8	−3.9	−4.2	−6.2	−8.3	−8.4	−8.0	−8.6	−3.0
Norway	16.1	12.6	12.3	12.7	16.3	17.3	14.1	18.6	13.8
Poland	−3.1	−2.8	−2.5	−4.0	−1.2	−2.7	−4.7	−5.0	−1.6
Portugal	−9.8	−8.0	−6.0	−7.5	−9.4	−9.9	−9.4	−12.0	−10.3
Slovak Republic	−8.3	−7.9	−5.9	−7.8	−8.5	−7.8	−5.3	−6.5	−1.3
Spain	−3.9	−3.3	−3.5	−5.3	−7.4	−9.0	−10.0	−9.7	−5.4
Sweden	3.8	4.0	7.1	6.6	6.8	7.8	8.2	9.3	7.2
Switzerland	8.2	8.8	13.3	13.3	13.9	15.2	9.1	1.8	8.4
Turkey	2.1	−0.4	−2.8	−3.8	−4.6	−6.1	−5.9	−5.5	−2.2
United Kingdom	−2.1	−1.7	−1.6	−2.1	−2.6	−3.3	−2.7	−1.5	−1.3
United States	−3.7	−4.3	−4.7	−5.3	−5.9	−6.0	−5.2	−4.9	−2.9
Euro Area	0.1	0.7	0.5	1.2	0.5	0.5	0.4	−0.8	−0.3
OECD Total	−1.0	−1.1	−1.0	−0.9	−1.4	−1.6	−1.3	−1.6	−0.7

Source: "Current account balances as a percentage of GDP", *OECD Economic Outlook*, No. 87, Preliminary Version, May 2010.

domestic investments. Notably this discrepancy creates balance-of-payments disequilibria. In 2001–2007 the savings and investment rates in the advanced countries have been on average 20 and 21 per cent of GDP, and within Developing Asia (China, India, Indonesia etc.) 39 and 35 per cent of GDP, respectively. By 2007 the figures for Developing Asia had already risen to 45 and 38 per cent of GDP, respectively. For the advanced economies as a whole the difference of 0.7 percentage points between investment and savings is negligible. The problem is that for the United States it is significant. The US gap was already in the 1980s

and ‘90s more than 2 percentage points and has grown during the 2000s up to 4–5 per cent of GDP. By 2007, the US gross savings had fallen to 14 per cent of GDP. For the UK the discrepancy between investment and savings in 2001–2007 was 2 percentage points.[82] It may be needless to say that, even though the discrepancy is measured between investments and savings, the rich countries are not characterized by an inclination to invest but – on the contrary – to consume.

A chronic US balance-of-payments deficit has been present since the 1970s. This is even a logical consequence of the dollar’s position as the main reserve currency. Part of the dollars earned by the rest of the world do not return to the US as purchases of US goods and services but is held as exchange reserves or remains to circulate as a means of payment in the world economy. The situation has aggravated since the late 1990s. During the 2000s, coinciding with the incubation of the financial crisis, the US current account deficits grew up to 2006, reaching a level of 6 per cent of GDP. In some other countries relative balance-of-payments deficits have been even higher, but these countries are not systemically as important as the US. The Euro Area is in a different position compared to the US in this respect. It includes countries with chronically large deficits (notably Spain, Portugal and Greece) but from the international monetary system point of view the deficits are “offset” by the surpluses of some other Euro Area countries (notably Germany, Benelux and Finland). (Table 5.)

In the United States, manufacturing export industries except the IT branch have virtually ceased to exist. Instead, international financial services have been developed. American consumers buy large amounts of industrial goods imported from abroad. In 2007, the US current account deficit still amounted to $727 billion or 5.2 per cent of GDP. This formed 58 per cent of the aggregate deficits of the OECD countries, or 76 per cent if the Euro Area is counted as one “country”.[83] (Table 5.) On the threshold of the bust, mid-2008, the

[82] Obstfeld & Rogoff (2009), pp. 8, 17–18, 20; James (2009), p. 36; “Table 5.1. Saving and Investment”, http://www.bea.gov/ (March 16, 2010); WEO Database, April 2010.

[83] Artus (2007), pp. 3–5; Skidelsky (2007), pp. 46–52; Cooper (2007), pp. 187–191, 194–200; Domanski (2007), pp. 203–221; Setser (2007), pp. 247–250; Obstfeld & Rogoff (2009), pp. 1–4, 7–28.

US gross foreign debt, measured as foreign holdings of US securities, amounted to $10.3 trillion or, excluding equities, to $7.4 trillion.[84]

The US balance-of-payments deficit has been financed by marketing securities, i.e. the US "exports", to a large extent, IOUs. Until the present financial crisis it was largely deemed that, since the United States issues reserve currency, a situation with a permanent foreign deficit could be sustainable indefinitely up to a certain proportion of the size of the economy. In 2007, an American economist stated:[85]

> "The United States has a vibrant, innovative economy. (---) It has an especially innovative financial sector (...). The United States has a *comparative advantage*, in a globalized market, *in producing marketable securities* [italics – TP], and in exchanging low-risk claims for higher risk assets."

The position of the US dollar as the main reserve currency – for the time being about two thirds of world reserves are kept in US dollars – has enabled huge balance-of-payments deficits to emerge, as the rest of the world has accumulated exchange reserves in dollars. The United States has utilized its central systemic position. It has developed an international financial structure within which the US appears as a "savvy investor". The bulk of foreign portfolio investments in the US consists of low-risk (at least it was believed so) but at the same time low-return debt securities, while the bulk of US portfolio investments in the rest of the world consists of high-risk but at the same time high-yielding equities. On this basis, the returns of US holdings of foreign securities, even though less in amount, have exceeded that of foreign holdings of US securities. Hence, also the US net foreign debt, at least until the recent financial crisis, has been less than accumulative balance-of-payments deficits would have brought within symmetric financial structures.[86] Measured as the

[84] Department of the Treasury. Federal Reserve Bank of New York. Board of Governors of the Federal Reserve System, "Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2008", April 2009 (Revised: Table 2 on November 18, 2009), http://www.treas.gov/tic/shla2008r.pdf (March 10, 2010), p. 3.

[85] Cooper (2007), p. 200.

[86] Eichengreen (2007), pp. 229–230; Schwartz (2009 a), spec. pp. 38–51; Schwartz (2009 b), pp. 92–96.

difference between total portfolio investments, the net debt was about 2–3 and excluding equities about 4–5 trillion dollars in 2007, i.e. from a seventh to a third part of GDP depending on the method of assessment. Yet, in 2008–2009 the US net position deteriorated considerably as a result of the world-wide fall in equity prices.[87]

The sustainability of permanent US current account deficits depends upon whether the rest of the world will continue to hoard dollar-denominated assets. Virtually all scholarly commentators regard the recent deficits as unsustainable. About 2 per cent of GDP has been mentioned as a sustainable level in the long run, and even this only provided that the US dollar retains its position as the main reserve currency.[88] The financial crisis of 2008–2009 at least gave a severe blow to the belief that high-risk assets could be transformed to low-risk ones by the professional skills of the American banking industry.

For the time being, the most significant imbalance in the financial US-rest-of-the-world relationship is that between the United States and China, which has developed even into mutual dependence. China has become the main source for imports of manufactures. The US-Chinese imbalance is to some extent exacerbated by the fact that the Chinese yuan is pegged to the dollar at an obviously undervalued rate, even though the basic reason lies in the different industrial structures combined with different consumption and saving habits. China and other Asian countries have gathered huge dollar reserves through

[87] The amounts of US vs foreign holdings are given for different points of time, the end of June and the end of December, respectively, thus the inaccuracy of their difference. Department of the Treasury. Federal Reserve Bank of New York. Board of Governors of the Federal Reserve System, "Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2007", April 2008, p. 12, http://www.treas.gov/tic/shl2007r.pdf; Department of the Treasury. Federal Reserve Bank of New York. Board of Governors of the Federal Reserve System, "Report on U.S. Portfolio Holdings of Foreign Securities as of December 31, 2008", October 2009, p. 3, http://www.treas.gov/tic/shc2008r.pdf (March 10, 2010) ; Department of the Treasury. Federal Reserve Bank of New York. Board of Governors of the Federal Reserve System, "Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2009", April 2010, Revised: Table 2 on May 13, 2010, http://www.treas.gov/tic/shl2009r.pdf (May 26, 2010).

[88] Cf. Skidelsky (2007), pp. 46–49; Setser (2007), pp. 247–250; James (2009), pp. 40–44; Cohen (2009), p. 163; Calleo (2009), pp. 187–190; Kirshner (2009), pp. 211–215; Obstfeld & Rogoff (2009), pp. 28–34; Lybeck (2009), pp. 230–232.

export surpluses. In the 2000s the Chinese foreign-exchange reserves grew vigorously, from the equivalent of 166 billion US dollars at the end of 2000 to the equivalent of 1.9 trillion dollars at the end of 2008, and 2.4 trillion dollars at the end of 2009. From 2006 on, China has held, after Japan, the second largest portfolio of US securities: US$1.5 trillion (excluding equities, US$1.4 trillion) in mid-2009. China holds the largest portfolio of US debt securities, about half of them in Treasury securities and the other half in private ones. Characteristic of the Chinese monetary situation is that it is mainly the central bank that holds the large funds of foreign currency-denominated assets, while, at the same time, the population holds large savings in renminbi kept in depository banks, unwilling to spend the money by buying more domestic goods. These two groups of funds are isolated from each other, since renminbi is not freely convertible on capital account.[89]

The problem of huge budget deficits and accumulated public debts has arisen when political decision-makers have preferred debt financing to taxation to please their constituents. The deficits of 2004–2006 were by no means warranted from a stability point of view. On the contrary, they were pro-cyclical policies in the circumstances of economic boom. Also this problem is most severe in the United States from the world economy point of view.

During 2002–2007 the annual average of US federal budget deficit was 2–4 per cent of GDP, which raised the total central government debt to $5.1 trillion, or 36 per cent of GDP in 2007. At the same time, the total US public (general government) debt amounted to 62 per cent of GDP. China has become the most important country

[89] Artus (2007), pp. 5–14; Lee & McKibbin (2007), pp. 265–275; Schwartz (2009 a), pp. 63–67; Obstfeld & Rogoff (2009), pp. 17–20; Nojonen (2009, pp. 41–47; Department of the Treasury. Federal Reserve Bank of New York. Board of Governors of the Federal Reserve System, “Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2006”, May 2007, http://www.treas.gov/tic/shl2006r.pdf (March 10, 2010); Department of the Treasury. Federal Reserve Bank of New York. Board of Governors of the Federal Reserve System, “Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2009”, April 2010, Revised: Table 2 on May 13, 2010, http://www.treas.gov/tic/shl2009r.pdf (June 23, 2010); “Gold & Foreign Exchange Reserves”, http://www.pbc.gov.cn/english (June 23, 2010).

Table 6. Central government financial balances of the leading OECD countries, 2001–2009, per cent of GDP.

	2001	2002	2003	2004	2005	2006	2007	2008	2009
Canada	1.1	0.8	0.3	0.8	0.1	0.8	1.0	0.2	−2.0
France	−2.1	−3.1	−3.6	−2.6	−2.6	−2.1	−2.3	−2.8	−6.0
Germany	−1.3	−1.7	−1.8	−2.4	−2.1	−1.5	−0.8	−0.6	−1.6
Italy	−3.1	−3.1	−3.0	−3.0	−4.0	−2.8	−2.0	−2.6	−4.8
Japan	−5.9	−6.7	−6.7	−5.2	−6.2	−1.0	−2.6	−2.6	−5.8
United Kingdom	0.8	−1.9	−3.4	−3.1	−3.0	−2.7	−2.7	−4.6	−11.1
United States	0.3	−2.6	−3.8	−3.6	−2.8	−1.8	−2.2	−5.4	−10.2
less social security	−1.3	−4.2	−5.2	−4.9	−4.1	−3.3	−3.5	−6.7	−11.0

Source: "Central government financial balances", *OECD Economic Outlook*, No. 87, Preliminary Version, May 2010.

to subscribe to US Treasury securities, thus financing balance-of-payments deficit at the same time.

The United States is by no means the only deeply indebted nation. The most indebted state is Japan. In 2007, the central government debt amounted to an equivalent of 8.5 trillion US dollars, or 164 per cent of GDP, while the total public (general government) debt reached 167 per cent of GDP.

Many other OECD countries have public debts which are relatively higher than that of the United States. Within the EU, a large number of euro countries failed already during the boom years to keep their public debt within the maximum reference value of 60 per cent of GDP, provided for by the EMU. In some cases the excess has become disproportionate.

The Economic and Monetary Union, created within the EU in the 1990s, was designed to resist excessive public deficits and excessive public debts through budgetary discipline. A supplementary protocol to the Treaty of Maastricht (1992) defined the reference values for the maximum of public deficit and public debt, 3 and 60 per cent of GDP, respectively[90]. The Stability and Growth Pact (SGP)[91] of 1997 strove

[90] "Protocol on the Excessive Deficit Procedure", Art. 1, *Official Journal of the European Communities*, *C 191*, 29/07/1992.

[91] The Stability and Growth Pact (SGP) of 1997 consists of the "Resolution of the European Council on the Stability and Growth Pact Amsterdam, 17 June 1997", *Official Journal of the European Communities*, *C 236*, 02/08/1997; and of the regulations 1466/97 and 1467/97, July 7, 1997, *Official Journal of the European Communities, L 209*, 02/08/1997.

Table 7. Total central government debt of OECD countries, 2001–2009, per cent of GDP.

	2001	2002	2003	2004	2005	2006	2007	2008	2009
Australia	9.6	8.6	7.5	6.7	6.3	5.8	5.2	4.9	8.1
Austria	60.7	60.4	60.9	62.2	62.1	60.6	58.1	59.6	64.3
Belgium	99.1	97.9	95.4	92.8	91.8	87.6	85.3	90.2	95.3
Canada	39.7	38.1	35.9	32.1	30.2	28.0	25.1	28.6	35.7
Czech Republic	14.7	16.1	19.1	21.1	23.2	24.9	25.2	27.1	32.5
Denmark	52.0	51.6	49.6	47.0	39.3	32.7	27.8	32.4	37.8
Finland	44.4	41.3	43.5	41.9	38.2	35.6	31.2	29.5	37.6
France	48.3	49.9	51.9	52.6	53.3	52.1	52.1	54.2	60.8
Germany	34.6	36.1	37.7	39.2	40.4	40.9	39.4	38.8	43.8
Greece	109.7	109.2	105.8	108.3	110.3	107.5	105.8	109.6	125.7
Hungary	50.5	53.6	56.3	55.7	58.1	61.9	61.3	68.2	72.7
Iceland	39.2	35.3	33.3	28.2	19.4	24.8	23.2	44.3	87.2
Ireland	30.9	27.9	26.9	25.4	23.6	20.3	19.8	27.7	46.0
Italy	102.7	99.5	96.8	96.2	97.5	96.7	95.2	98.0	106.6
Japan	123.6	137.6	140.9	156.7	164.3	161.4	164.2	178.0	*183.8*
Korea	17.4	17.6	20.7	23.7	27.6	30.1	29.7	29.0	32.6
Luxembourg	3.1	2.7	1.7	1.4	0.8	1.4	1.4	8.2	8.6
Mexico	20.5	21.9	22.1	20.7	20.2	20.5	21.0	24.5	28.2
Netherlands	41.3	41.5	43.0	43.8	43.0	39.2	37.8	50.1	49.9
New Zealand	30.2	28.5	26.4	23.8	22.1	21.6	20.4	20.6	27.5
Norway	18.1	19.0	21.3	18.4	17.2	12.5	11.7	13.8	26.1
Poland	36.4	40.6	44.9	43.6	44.8	45.1	42.6	44.8	47.1
Portugal	56.0	58.7	60.2	63.0	68.2	69.8	69.2	71.2	81.1
Slovak Republic	36.0	35.1	35.1	38.4	33.1	29.2	28.1	26.3	33.6
Spain	46.3	43.9	40.7	39.3	36.4	33.0	30.0	33.7	46.1
Sweden	48.6	46.8	47.7	46.6	46.2	42.3	36.4	35.5	37.8
Switzerland	24.8	28.2	28.3	28.1	28.1	25.2	23.2	22.5	20.7
Turkey	74.1	69.2	62.2	56.6	51.1	45.5	39.6	40.0	46.3
United Kingdom	38.8	39.1	38.7	40.0	43.4	43.3	42.6	61.3	75.1
United States	32.4	33.2	34.9	36.0	36.1	36.0	35.6	40.0	53.1

Source: "Total central government debt (% of GDP)", OECD.Stat; For Japan 2009: "Central Government Debt. As of December 31, 2009", February 10, 2010, http://www.mof.go.jp/ (September 12, 2010).

to ensure that the euro countries would continue to observe the fiscal-policy reference values even after having met the fiscal policy-related convergence criteria for the third stage of EMU (common currency), based on the above-mentioned EMU reference values. The SGP, however, only explicitly defines the excessive deficit, a maximum of 3 per cent of GDP, as the reference value for Community

Table 8. General government financial balances in OECD countries and in EU countries, 2001–2009, per cent of GDP.

	2001	2002	2003	2004	2005	2006	2007	2008	2009
Non-EU OECD									
Australia	−0.5	0.7	1.4	1.1	1.4	1.5	1.7	0.3	−3.9
Canada	0.7	−0.1	−0.1	0.9	1.5	1.6	1.6	0.1	−5.1
Iceland	−0.7	−2.6	−2.8	0.0	4.9	6.3	5.4	−13.5	−9.1
Japan	−6.3	−8.0	−7.9	−6.2	−6.7	−1.6	−2.4	−2.1	−7.2
Korea	4.3	5.1	0.5	2.7	3.4	3.9	4.7	3.0	0.0
New Zealand	1.7	3.6	3.8	3.9	4.5	5.1	4.0	0.4	−3.5
Norway	13.3	9.2	7.3	11.1	15.1	18.5	17.7	19.1	9.7
Switzerland	−0.1	−1.2	−1.7	−1.8	−0.7	0.8	1.6	2.5	0.7
United States	−0.6	−4.0	−5.0	−4.4	−3.3	−2.2	−2.8	−6.5	−11.0
Euro Area									
Austria	−0.0	−0.7	−1.4	−4.4	−1.7	−1.5	−0.4	−0.4	−3.4
Belgium	0.4	−0.1	−0.1	−0.3	−2.7	0.3	−0.2	−1.2	−6.0
Cyprus	−2.2	−4.4	−6.5	−4.1	−2.4	−1.2	3.4	0.9	−6.1
Finland	5.0	4.0	2.4	2.3	2.7	4.0	5.2	4.2	−2.2
France	−1.5	−3.1	−4.1	−3.6	−2.9	−2.3	−2.7	−3.3	−7.5
Germany	−2.8	−3.7	−4.0	−3.8	−3.3	−1.6	0.2	0.0	−3.3
Greece	−4.5	−4.8	−5.6	−7.5	−5.2	−3.6	−5.1	−7.7	−13.6
Ireland	0.9	−0.3	0.4	1.4	1.6	3.0	0.1	−7.3	−14.3
Italy	−3.1	−2.9	−3.5	−3.5	−4.3	−3.3	−1.5	−2.7	−5.3
Luxembourg	6.1	2.1	0.5	−1.1	0.0	1.4	3.6	2.9	−0.7
Malta	−6.4	−5.5	−9.8	−4.7	−2.9	−2.6	−2.2	−4.5	−3.8
Netherlands	−0.2	−2.1	−3.1	−1.7	−0.3	0.5	0.2	0.7	−5.3
Portugal	−4.3	−2.9	−2.9	−3.4	−6.1	−3.9	−2.6	−2.8	−9.4
Slovak Republic	−6.5	−8.2	−2.8	−2.4	−2.8	−3.5	−1.9	−2.3	−6.8
Slovenia	−4.0	−2.5	−2.7	−2.2	−1.4	−1.3	0.0	−1.7	−5.5
Spain	−0.6	−0.5	−0.2	−0.3	1.0	2.0	1.9	−4.1	−11.2
Non-Euro EU countries									
Bulgaria	0.6	−0.8	−0.3	1.6	1.9	3.0	0.1	1.8	−3.9
Czech Republic	−5.6	−6.8	−6.6	−3.0	−3.6	−2.6	−0.7	−2.7	−5.9
Denmark	1.5	0.4	0.1	2.1	5.2	5.2	4.8	3.4	−2.7
Estonia	−0.1	0.3	1.7	1.6	1.6	2.5	2.6	−2.7	−1.7
Hungary	−4.0	−8.9	−7.2	−6.4	−7.9	−9.3	−5.0	−3.8	−4.0
Latvia	−2.1	−2.3	−1.6	−1.0	−0.4	−0.5	−0.3	−4.1	−9.0
Lithuania	−3.6	−1.9	−1.3	−1.5	−0.5	−0.4	−1.0	−3.3	−8.9
Poland	−5.3	−5.0	−6.2	−5.4	−4.1	−3.6	−1.9	−3.7	−7.1
Romania	−3.5	−2.0	−1.5	−1.2	−1.2	−2.2	−2.5	−5.4	−8.3
Sweden	1.6	−1.2	−0.9	0.8	2.3	2.5	3.8	2.5	−0.5
United Kingdom	0.5	−2.1	−3.4	−3.4	−3.4	−2.7	−2.8	−4.9	−11.5
Euro Area (16)	−1.9	−2.6	−3.1	−2.9	−2.5	−1.3	−0.6	−2.0	−6.3
Total OECD	−1.4	−3.3	−4.0	−3.4	−2.7	−1.2	−1.2	−3.3	−7.9

Sources: For non-EU countries, "General government financial balances", *OECD Economic Outlook*, No. 87, Preliminary Version, May 2010; for EU-27 countries, "General government deficit (–) and surplus (+); Percentage of GDP", Eurostat.

Table 9. General government debt in OECD countries and in EU countries, 2001–2009, per cent of GDP.

	2001	2002	2003	2004	2005	2006	2007	2008	2009
Non-EU OECD									
Australia	21.8	19.8	18.3	16.6	16.1	15.3	14.3	13.6	19.2
Canada	82.7	80.6	76.6	72.6	71.6	69.5	65.0	69.7	82.5
Iceland	75.0	72.0	71.0	64.5	52.6	57.4	53.3	96.2	122.7
Japan	143.7	152.3	158.0	165.5	175.3	172.1	167.0	173.8	192.9
Korea	16.6	15.8	17.4	21.4	26.8	30.1	30.4	32.2	34.9
New Zealand	35.1	33.1	31.0	28.3	27.0	26.7	25.8	29.1	35.0
Norway	33.0	40.6	50.2	52.7	49.1	60.5	58.6	56.1	49.2
Switzerland	51.2	57.2	57.0	57.9	56.4	50.3	46.5	42.4	41.6
United States	54.4	56.8	60.1	61.1	61.4	60.9	61.9	70.4	83.0
Euro Area									
Austria	67.1	66.5	65.5	64.8	63.9	62.2	59.5	62.6	66.5
Belgium	106.6	103.5	98.5	94.2	92.1	88.1	84.2	89.8	96.7
Cyprus	52.1	64.6	68.9	70.2	69.1	64.6	58.3	48.4	56.2
Finland	42.5	41.5	44.5	44.4	41.7	39.7	35.2	34.2	44.0
France	56.9	58.8	62.9	64.9	66.4	63.7	63.8	67.5	77.6
Germany	58.8	60.4	63.9	65.8	68.0	67.6	65.0	66.0	73.2
Greece	103.7	101.7	97.4	98.6	100.0	97.8	95.7	99.2	115.1
Ireland	35.6	32.2	31.0	29.7	27.4	24.9	25.0	43.9	64.0
Italy	108.8	105.7	104.4	103.8	105.8	106.5	103.5	106.1	115.8
Luxembourg	6.3	6.3	6.1	6.3	6.1	6.5	6.7	13.7	14.5
Malta	62.1	60.1	69.3	72.3	70.1	63.7	61.9	63.7	69.1
Netherlands	50.7	50.5	52.0	52.4	51.8	47.4	45.5	58.2	60.9
Portugal	52.9	55.6	56.9	58.3	63.6	64.7	63.6	66.3	76.8
Slovak Republic	48.9	43.4	42.4	41.5	34.2	30.5	29.3	27.7	35.7
Slovenia	26.8	28.0	27.5	27.2	27.0	26.7	23.4	22.6	35.9
Spain	55.5	52.5	48.7	46.2	43.0	39.6	36.2	39.7	53.2
Non-Euro EU									
Bulgaria	67.3	53.6	45.9	37.9	29.2	22.7	18.2	14.1	14.8
Czech Republic	24.9	28.2	29.8	30.1	29.7	29.4	29.0	30.0	35.4
Denmark	49.6	49.5	47.2	45.1	37.8	32.1	27.4	34.2	41.6
Estonia	4.8	5.7	5.6	5.0	4.6	4.5	3.8	4.6	7.2
Hungary	52.0	55.6	58.4	59.1	61.8	65.6	65.9	72.9	78.3
Latvia	14.0	13.5	14.6	14.9	12.4	10.7	9.0	19.5	36.1
Lithuania	23.1	22.3	21.1	19.4	18.4	18.0	16.9	15.6	29.3
Poland	37.6	42.2	47.1	45.7	47.1	47.7	45.0	47.2	51.0
Romania	25.7	24.9	21.5	18.7	15.8	12.4	12.6	13.3	23.7
Sweden	54.4	52.6	52.3	51.1	50.8	45.7	40.8	38.3	42.3
United Kingdom	37.7	37.5	39.0	40.9	42.5	43.5	44.7	52.0	68.1
Euro Area (16)	68.2	68.0	69.1	69.5	70.1	68.3	66.0	69.4	78.7
Total OECD	69.7	71.4	73.3	74.8	76.4	74.6	73.0	79.0	90.3

Sources: For non-EU countries, "General government gross financial liabilities. Per cent of nominal GDP", *OECD Economic Outlook*, No. 87, Preliminary Version, May 2010; for EU-27 countries, "General government consolidated gross debt as a percentage of GDP", Eurostat.

interference, in the expectation that, as the rule, public debt would settle accordingly. In principle, the Community can sanction a non-conforming country by levying a non-interest bearing deposit which can be turned into a fine, but the procedures are complicated and the stipulations do not contain an unambiguous definition of "excessive deficit" related to the reference value.[92] The reform of SGP in 2005 rather relaxed the rules further.[93] From the onset the EMU countries had weak preconditions for effective fiscal-policy coordination due to intra-Community incoherences, which explains why the Euro Area countries were incapable even to observe common rules as long as economic development proceeded favourably.[94] Even the possibility to forestall excessive public indebtedness was neglected since the EMU and SGP stipulations do not prevent member countries from practising pro-cyclical fiscal policies during times of economic boom.[95]

On the threshold of the crisis, in 2007, the most indebted state was Italy with a central government debt equivalent to 2.2 trillion US dollars, or 95 per cent of GDP, and a total public (general government) debt amounting to 104 per cent of GDP. In Greece, the central government debt amounted to the equivalent of 353 billion US dollars, or 106 per cent of GDP, and the general government debt to 96 per cent of GDP. Belgium has been highly indebted for a long time but the situation is consolidated. In 2007, the central government and general government debt still amounted to 85 and 84 per cent of GDP, respectively. Germany, France and Portugal and, outside the Euro Area, Hungary exceeded the reference value of 60 per cent of GDP. The combined general government debt of the Euro Area exceeded the reference value, amounting to 66 per cent of GDP. (Tables 6–9.)

The stimulus policies carried out from 2008 onwards have aggravated public deficits and debts even further (see pp. 93–95). During the economic crisis, however, as a result of the temporary decline of world trade, global external imbalances shrank to some extent. From 2008 to 2009, for example, the US current account

[92] Cabral (2001), pp. 140–150.

[93] Regulations 1055/2005 and 1056/2005, June 27, 2005, *Official Journal of the European Union, L 174*, 7 July 2005.

[94] Virén (2001), pp. 261–268.

[95] Korkman (2001), pp. 304, 308.

deficit sank from 5 to 3 per cent of GDP, while the combined surplus of Developing Asia current account sank from 6 to 4 per cent and that of China from 9 to 6 per cent. Nevertheless, the external debt of the US and the exchange reserves of Developing Asia continued to grow, albeit at a slowed-down pace, and the IMF expects the narrowing to be temporary.[96]

[96] IMF, *World Economic Outlook*, April 2010, pp. 5–5, 109–110.

4. The Crisis of 2008–2009

The trap of the American housing market

The crises of the 1980s and 1990s were overcome, except perhaps for the Japanese one, through the anti-crisis action of the authorities of the countries concerned or through international rescue operations. This fuelled the general belief, prevalent during the boom of 2003–2007, that "the business cycle had been tamed". It was largely believed that the modern financial system was "resilient" to self-correct disturbances and, with more severe disturbances, the government and central bank, when needed in concerted international action, would develop an anti-crisis policy to redirect the development back to the growth path relatively easily. This optimism was preached, for example, by Alan Greenspan, the Chairman of the Federal Reserve in 1987–2006, and supported unreservedly by the George W. Bush administration. The supreme US regulatory authority, the Securities and Exchange Commission (SEC), which was established in the aftermath of the Great Depression in 1934, seems to have regarded its regulatory role as largely obsolete. The Fed's interest-rate policy, which in the early 2000s turned recession to growth, seemed to be the latest prove of American financial resiliency.[97]

During the first almost a decade of its existence, 1999–2007, the G-20 meetings could also record relatively favourable developments in the world economy. Globalization seemed to bring about mainly benefits. The G-20 meeting in 2000 noted a "continued strengthening of global economic growth". In 2001, the G-20 meeting was compelled to record "a global economic slowdown" and, in 2002, a "slower than expected recovery". Already the 2003 meeting could note that "a global economic recovery is underway". The 2004 meeting "welcomed the favourable macroeconomic environment in the world economy with high growth at low inflation rates" and the 2005 meeting "welcomed the ongoing expansion of the world economy", although it was also compelled to observe "the low growth and increasing poverty in some developing countries". The 2006 G-20 meeting could record that "the world economy continues

[97] See, e.g. Krugman (2008), pp. 9–29, 140–152.

to expand at a solid pace", although it was also expected to "slow down slightly" in the near future. Still in November 2007 the G-20 "welcomed the continued strong growth of the global economy in the first half of 2007" but noted that "downside risks" had increased as the result of "recent financial market disturbances".[98] To sum up, the political decision makers of the G-20 did not recognize the scale of the risks which were incubating in the US housing market.

In the midst of general optimism, financial experts also discussed the possibility of financial crises. Especially the economists of the IMF were preoccupied by these threats.[99] In late 1996, Fed chairman Greenspan launched the much-cited phrase "irrational exuberance" referring to the actual "dot-com boom". He, however, seemingly believed that, in the end, excesses will be corrected by the market without severe consequences – and he was right that time. Ben Bernanke – then member of the Board of Governors of the Federal Reserve System but soon, from 2006 onwards, the successor of Greenspan – opined in 2005 that "the risk of a disorderly adjustment in financial markets always exists, and the appropriately conservative approach for policymakers is to be on guard for any such developments". But nor did he truly believe that such a threat would materialize. In Autumn 2008 Greenspan had to admit that the "intellectual edifice" he had believed in had collapsed.[100]

What was crucial for the recent crisis was that it began in the United States, the centre of the world economy. The crisis unfolded in the US housing market, which involves huge economic values. Securitization of mortgages, a general US practice, links the US housing market closely to the global financial system. At the end of 2007, the US home loans amounted to $10.5 trillion, or three quarters of the US GDP. The bulk of the mortgages, 85 per cent, were securitized. A considerable part of the securities were marketed abroad, mainly to Western Europe.[101] To be sure, the United States

[98] See List of documents of G-20 meetings, 1999–2007, pp. 129–129.

[99] Cf. Hoelscher (2003).

[100] Cf. Krugman (2008), p. 142; Fox (2009), pp. xii, 257–258; Obstfeld & Rogoff (2009), pp. 6 (quot.).

[101] Schwartz (2009 a), pp. 95–104; Lybeck (2009), pp. 55–57, 75–76; "Flow of Funds Accounts of the United States. Flows and Outstandings. Fourth Quarter 2009", Federal Reserve statistical release, http://www.federalreserve.gov/releases/ (18.3.2010).

was not the only country with a vigorous housing boom; there was an analogous development notably in the UK, Spain, Ireland and Australia.[102] However, the US was the epicentre of the world-wide financial crisis.

The US banking industry was the generator of the crisis. It can be said that excessive credit expansion caused the crisis. This is, however, too formalistic an expression to describe the developments. Quite obviously those Keynesian economists – notably Robert Shiller, George Akerlof, Joseph Stiglitz, Paul R. Krugman – are right who claim that the crisis was created by a chain of people from mortgage brokers and mortgage initiators to investments bankers, hedge-fund leaders, and securities-rating agencies, in their irresponsible, uninhibited greed to enhance their incomes, related to short-term profits. Incentive systems became perverse since they were based on the extent of transactions. Bankers took extraordinary risks and utilized all the possibilities of the American financial system to boost credit expansion in the short run. They deceived both the borrowers and the investors to expand their unsustainable business to show, in the short run, maximal profits on the basis of which they cashed their bonuses. It has been pointed out that especially the inadequate regulation of the so-called shadow banking – typically investment banks, off-balance sheet affiliates of banks called structured investment vehicles (SIV) and hedge funds – was the main circumstance that enabled the excessive credit expansion.[103]

As stated above, in connection with balance-of-payments deficits, the US financial system maintained a pattern of arbitrage within which the US borrowed from abroad short-term at a low interest rate and invested abroad long-term in higher-yielding assets (see p. 55). According to Herman Schwartz, the United States experienced in the long 1990s, approximately 1991–2005, a period of differential growth; the GDP growth rates were higher in the United States than in the other advanced economies. The arbitrage system was like a money pump which returned the trade deficits back to boost the US aggregate demand and, through the Keynesian multiplier effect, the economic growth in the United States. Economic growth was fostered further by imported disinflation as cheap consumer goods

[102] Lybeck (2009), pp. 19, 55, 60, 216.

[103] Spec. Krugman (2008), pp. 158–164; Stiglitz (2010), pp. 1–26.

from emerging Asia. The strategic position of the United States as the issuer of dollars, the main reserve currency, gave the US access to this apparently unrestricted credit which was channeled, for example, to boost the housing market. According to Schwartz, expressly this arbitrage enabled the extraordinarily vigorous growth of the US housing market, which further explains the high GDP growth rates in the United States.[104] It is noteworthy that comparable balance-of-payments deficits were also characteristic of the minor housing-boom countries (the UK, Spain, Ireland, Australia).[105]

The US housing boom lasted one and a half decades from the early 1990s to 2006. The boom was encouraged by the Fed's policy of low interest rates in 2001–2004. Credit expansion raised housing prices. Since the Great Depression of the 1930s housing prices had virtually never sunk. This historical record created a widely-based belief that housing prices "could not" sink in the present either. Eventually, when rising prices had been experienced for long enough the American housing finance was based on the expectation that prices would rise indefinitely. Financial institutions became ever bolder in granting loans. By the mid-2000s, the American housing market was overwhelmed by speculative fever. The housing market seemed to be an enriching automat for the whole American nation.

The US home-loans system contained a number of elements prone to undermine financial stability. The first grievance was the American practice that the mortgage alone suffices for collateral, which tended to make the borrowers exceed their ability to serve their loans. This created the first precondition for disproportionate expansion of home loans. Even more fateful were the subprime loans, backed by the "American dream", the general political-ideological endeavour to enable as many American families as possible to acquire a home of their own. Subprime loans were granted to borrowers who did not qualify as creditworthy, i.e. prime, customers. Related to subprime were the Alt-A loans, for which the creditworthiness of a borrower could not be documented. Scrutiny of the borrowers' creditworthiness was mainly carried out by mortgage brokers, who mediated the home loans and whose incomes were dependent on the extent of transactions; they had a high economic incentive to

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[104] Schwartz (2009 a), spec. pp. 3–13, 21–26, 38–51; Schwartz (2009 b), pp. 92–105.

[105] Lybeck (2009), pp. 232.

originate as many mortgages as possible. A subprime or an Alt-A loan promised to the lender high yields in the form of high interest rate after a transitional period of 2–3 years, while for the borrower rising housing prices predicted the possibility to qualify as a prime customer with a positive equity position in a couple of years when the value of the dwelling would exceed the outstanding debt.

Subprime loans as an institution to enable dwelling acquisition even for poor Americans, date back to the 1990s. Yet only in the final stages of the American housing boom, 2004–2007, did they reach a scale which eventually proved to be fatal. It has been estimated that a fifth of new home loans were either subprime or Alt-A in 2006.[106]

The US banking system has developed a large range of "innovative" financial instruments for domestic and foreign investors. Asset-backed securities (ABS), based on personal debts, is a US invention. Mortgages are the main underlying assets for ABSs. Securitization of mortgages dates back to the early 1980s. Mortgage and investment banks buy mortgages from loan banks and package them into marketable mortgage-backed securities (MBS) and structured products called collateralized debt obligations (CDO), also containing underlying assets other than mortgages. Securitization guaranteed, in principle, almost indefinite credit expansion since a new loan could be granted as soon as the previous one had been sold. There are also other countries which enable securitization of mortgages, for example, Sweden, but in the United States it became a large-scale industry.[107]

The reverse side of vigorous credit expansion was high debt leverage. Within the shadow banking system, not subject to normal banking regulation, acquisitions of MBSs and CDOs were financed by issuing short-term securities called asset-backed commercial papers (ABCP). The idea was to profit from the interest-rate spread between the long-term securities and short-term borrowing. Parent banks were obliged to maintain a credit line for their SIVs for the eventuality of adverse interest-rate development, an option which was not expected to materialize. The system was based on the assumption

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[106] Obstfeld & Rogoff (2009), pp. 14–16; Schwartz (2009 a), pp. 174–182; Lybeck (2009), pp. 53–62.

[107] Schwartz (2009 a), pp. 98–104; Lybeck (2009), pp. 70–74.

that the MBS and CDO values would not deteriorate essentially and, hence, it collapsed in Autumn 2008.[108]

At the outbreak of the full-scale financial crisis in 2008, the CDOs caused most confusion and panic because of their complex structure and opaque nature. The underlying mortgages were gathered into a pool on the basis of which the CDOs were formed. They were divided into different tranches with different seniority, within which an investor could choose securities with different returns connected with different degrees of risk, as well as with different maturities. Reimbursement of principal and interest payments to investors took place in the order of seniority. The higher tranches were privileged to be reimbursed first but they yielded returns at lower interest rates. The lower tranches, known also as "toxic waste", yielded higher returns, or at least promised to, but they were the first to absorb credit defaults. One rational for forming complex mortgage derivatives was to diversify default risk, but the non-transparency of these products rather meant that a default "contaminated" a large number of securities.[109]

When the supply of creditworthy buyers was exhausted the banks resorted to people who could not actually afford their mortgage, also known as "NINJAs" ("no income, no job, and no assets"). In 2005 and 2006, over 80 per cent of subprime mortgages were securitized. The dubious nature of these securities was fully revealed only when the crisis became obvious. Many economists conclude that, in many cases, mortgage brokers and bankers intentionally created "junk" products to enhance their rewards. Mortgage originators did not seriously assess the borrowers' creditworthiness because they had planned to sell the mortgage to a securitizer, and securities raters gave these securities high ratings to receive their fees. According to Herman Schwartz, the banks (and the subprime borrowers) needed continuous appreciation of housing values of about 10 per cent annually. George Akerlof and Robert Shiller regard the subprime loans as a "corrupt" practice. According to Joseph Stiglitz, bank executives utilized asymmetric information to deceive and cheat the borrowers and investors. Perverse incentive systems were enabled by the absence of effective regulations, a state of affairs lobbied by

[108] Krugman (2008), pp. 158–162; Schwartz (2009 a), pp. 186–188.

[109] Schwartz (2009 a), pp. 185–186.

Wall Street. The actors were indifferent to consequences within the larger financial system.[110]

The American financial system was designed to sustain even setbacks. At the end of 2007, banks both in America and in Western Europe generally fulfilled the Basel standards of capital adequacy even with a buffer marginal. Credit default swaps (CDS), issued by financial institutions, were meant to protect the banks and the ABSs against credit risks. To safeguard the investors, banks retained a proportion of securities to absorb losses. Diversification of risks tended to create an atmosphere of carelessness. Ultimately, mortgage-related securities seemed to be secured because housing prices were not expected to fall. The stabilizers in the American financial system were, however, sized for more modest price falls than actually happened, while, at the same time, high leverage lowered the degree to which the banking system could bear a fall in asset values. A larger sizing would have curtailed the credit expansion which formed the basis for bonuses.[111]

The events in the US in 2007–2008 followed, by and large, the Minsky-Kindleberger pattern of a financial crisis. As long as the housing prices rose, a default by a borrower was not a problem for the lender since the collateral could be sold at a profit. The prices, however, began to fall in mid-2006. The downward movement was first slow but accelerated approximately a year later. The stage of distress began in 2007 when delinquencies and foreclosures rose rapidly.[112]

Credit losses and guarantees against credit default caused recapitalization requirements which greatly exceeded the financial institutions' possibilities. Since 2007, the United States has experienced dozens of bank failures. Most were merged with stronger banks, but some declared outright bankruptcy. The whole US banking system would have collapsed without governmental intervention. The process was intercepted at a stage when panic had lasted for about six months.

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[110] Shiller (2008), p. 6; Schwartz (2009 a), pp. 188–189; Akerlof & Shiller (2009), pp. 36–37; Obstfeld & Rogoff (2009), pp. 24–25; Stiglitz (2010), pp. 77–95.

[111] Lybeck (2009), pp. 79–82.

[112] E.g. Schwartz (2009 a), pp. 183–184.

The first visible sign of crisis was the sale of the investment bank Bear Stearns to JPMorgan Chase in March 2008, which the Fed and the Treasury arranged to protect the counterparties' claims. The position of thrift banks operating in California, where the dwelling prices fell most, became especially strained. The Countrywide Bank was bought by the Bank of America in July 2008. Soon thereafter the largest thrift bank, IndyMac, was first taken over by the state authorities and later on sold to the private sector. In early September 2008, as the result of credit losses, the federal government took control over the leading mortgage banks known as Fannie Mae and Freddie Mac. Panic arose on September 15, 2008, when the investment bank Lehman Brothers fell without protection by the state for the counterparties. Two days later, the federal government rescued by nationalization the world-wide-operating insurance company, American International Group (AIG), the main issuer of CDSs, but this did not calm the panic. In late September the thrift bank Washington Mutual, also operating largely in California, was taken over by the state and later on sold to JPMorgan Chase. Wachovia bank was purchased by Wells Fargo.

Panic was fuelled further on September 29, when the House of Representatives first rejected the Government's rescue plan. A scandalous fraud, committed by Bernard Madoff, the former Chairman of the Nasdaq stock exchange, was revealed in December 2008. What was fatal for the credibility of the entire financial system was that many established financial institutions, not only in America but also in Europe, had in good faith invested in his fraudulent undertaking. General panic, fuelled by the international mass media, continued until approximately Spring 2009, when, at last, concerted international action resulted in a gradual resumption of confidence in the financial markets.

The financial market was paralyzed in Autumn 2008,a phenomenon called a credit crunch. Most distinctively this happened in the interbank market, when banks did not trust each other's solvency. Other lending was also tightened for the same reason, even though the Fed supplied banks with liquidity at an affordable interest rate.[113]

[113] See Krugman (2008), spec. pp. 165–180; for a chronology of US and international banking events 2007–2009, see Lybeck (2009), pp. 26–46.

International propagation of the crisis

The banking crisis spread immediately to Europe, where many banks were involved in American mortgage-related securities. The globalized mass media effectively spread panic sentiments.

Depreciations because of impaired assets were registered, in the first place, by the Swiss banks UBS and Crédit Suisse, in France by the BNP Paribas, in Germany by the IKB Deutsche Industriebank and the savings banks Landesbank Sachsen and Bayerische Landesbank, in the UK by the Hongkong and Shanghai Banking Corporation (HSBC) and Barclays Bank. On the other hand, the troubles of the German mortgage bank Hypo Real Estate, the British mortgage banks the Northern Rock and Bradford & Bingley, and in Ireland the Anglo-Irish Bank were caused by fluctuations in the domestic housing market. Fortis in the Benelux and the Royal Bank of Scotland (RBS) in the UK ran into difficulties after participating in the purchase and division of the Dutch bank ABN AMRO at an unsuitable point of time. Landesbank Sachsen was merged with Landesbank Baden Württemberg, while the Northern Rock, Bradford & Bingley and the Anglo-Irish Bank were nationalized; the British state also acquired majority ownership of the RBS.[114]

The most conspicuous was the Icelandic banking catastrophe, which will become a textbook example of adventurous banking. In terms of industrial policy, the Icelandic banking business in the early 2000s was the third line in efforts to diversify the Icelandic economy, whose exports had traditionally consisted of fishery products. The other two were aluminium and tourism, for which the abundant hydro-energy and the arctic-volcanic nature, respectively, provided the comparative advantage. It may not be surprising that the undertaking of the "Financial Vikings" gained enthusiastic support from the population as long as the business ran favourably. The financial construction was, however, based on a euphoric assumption that expansion would continue indefinitely. It could not sustain an essential fall in asset values.

The three Icelandic banks, Kaupthing, Landesbanki and Glitnir, carried out an unprecedented expansion in international operations in the early 2000s. They drew deposits and wholesale funding from

[114] Lybeck (2009), pp. 15–46, 70–89.

Northern Europe and acquired branch offices abroad, as well as foreign securities. They utilized the deficiencies of the Icelandic banking regulations to maximize short-term profits. What was fatal for the subsequent development was that offices abroad were organized in a way that placed foreign deposits under the Icelandic deposit guarantee – to avoid foreign supervisors visiting their premises. Prior to the failure, in mid-2008, their balance sheets amounted to ten times the Icelandic GDP. The outbreak of financial panic in September 2008 brought the three banks suddenly to insolvency, and they were nationalized in early October. The IMF, together with a number of North European countries, prepared a rescue programme consisting of loans, amounting to 5.1 billion US dollars, or more than 16 thousand dollars for each Icelandic inhabitant.[115]

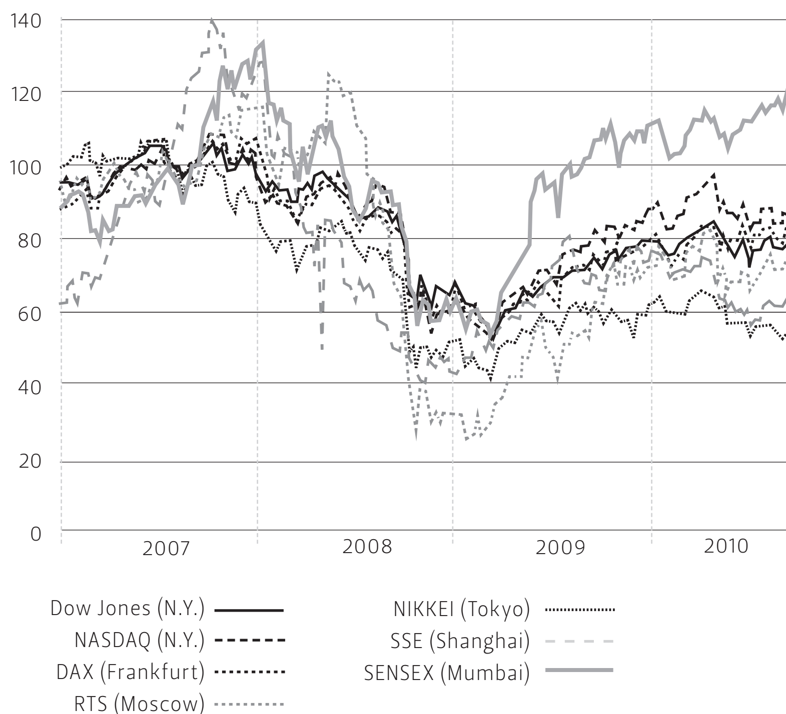
Swedish, Austrian and Italian banks acquired a strong position in the financial markets of the East European countries. Especially the Swedish Swedbank financed home loans in the Baltic countries and the Austrian Raiffeisen in Hungary. When a large number of borrowers lost the ability to serve their loans, the banks registered huge credit losses.

Austria was the main lender in Central and East European, the former Communist-ruled countries. Especially the cooperative bank Raiffeisen was active. Worst hit was Hungary, where households had taken large amounts of euro-denominated home loans, and which had additionally accumulated huge amounts of public debt and current-account deficits. As the exchange rates of most of these countries are based on floating, the recession resulted in depreciation of the local currencies, which further increased the debt burden in terms of domestic currency.[116]

Some Swedish banks, especially Swedbank, the successor to the former savings banks and agricultural cooperative banks, in the 2000s, developed large-scale banking businesses in the Baltic countries. The housing boom was vigorous in all the Baltic countries, and foreign currency-denominated loans from Swedish banks, especially Swedbank, formed the bulk of home loans in Latvia, Estonia and Lithuania. Especially Latvia was severely hit by the crisis;

[115] Lybeck (2009), pp. 178–180; Flannery (2009); "Economic programme in cooperation with IMF", http://www.iceland.org/ (May 3, 2010); Gylfason et. al. (2010), spec. pp. 146–154.

[116] Marer (2010), pp. 16–28



Based on weekly closing rates.
Sources: "Dow Jones Industrial Average", http://finance.yahoo.com/q?s=%5EDJI; "NASDAQ Composite", http://finance.yahoo.com/q?s=%5EIXIC&d=t; "DAX", http://uk.finance.yahoo.com/q?s=%5EGDAXI; "The RTS Stock Exchange Indices", http://www.rts.ru/s615; "NIKKEI 225", http://finance.yahoo.com/q?d=t&s=%5EN225; "SSE Composite Index", http://finance.yahoo.com/q?s=%5ESSEC; "Historical Values for BSE Indices", http://www.bseindia.com/ (September 18, 2010).

Figure 2. Development of main stock exchange indices, 2007–2010, daily average of 2007=100.

the situation was aggravated by large current-account deficits. The recession resulted in large credit losses to lenders from 2008 onwards, for Swedbank 1.78 per cent of lending in 2009, for Skandinaviska Enskilda Banken (SEB) and Nordea less.[117]

[117] Larin & Bromander (2010), pp. 24–26; Marer (2010), p. 19.

The slump most conspicuously affected the stock exchange rates which usually express economic fluctuations with exaggerated volatility. Especially at the end of September and in early October 2008 – as commented on by the mass media – the rates "dove" in "free fall". The fall was steepest in the week October 6–10. A number of main stock exchange indices, as measured from the peak in 2007 or early 2008 to the trough in late 2008 or early 2009, plummeted as follows: Dow Jones (N.Y.) –54 per cent; Nasdaq (N.Y.) –56 per cent; DAX (Frankfurt) –55 per cent; RTS (Moscow) –80 per cent; Nikkei (Tokyo) –61 per cent; SSE (Shanghai) –72 per cent; Sensex (Mumbai) –39 per cent. The upward turn began during a period from mid-March to mid-April 2009.[118] (Figure 2.)

Production fell sharply from Autumn 2008 to Spring 2009. The recession was felt most markedly in construction, investments and foreign trade. Housing construction halted first in the expectation of falling prices in the conditions of demand paralysis. Investors became cautious because of the expected decline in demand. Also the tightening of credit discouraged investments. The consumers became cautious with regard to non-necessary expenses. Producers were unwilling to enlarge their stockpiles, striving to melt down their inventories instead. To be sure, during 2009, the real world GDP fell by only 0.6 per cent on the basis of PPPs, but the fall was distributed unevenly both in world-wide comparison and within regional groups of countries. (If converted through market exchange rates, the global fall was deeper, 2 per cent.) Within the OECD as a whole the fall was 3.4 per cent from the third quarter of 2008 to that of 2009. World trade fell by 11 per cent in 2009.[119] In the advanced economies, the unemployment rate rose to about 8 per cent of the labour force on average and is expected to stay at this relatively high level at least for the next couple of years.[120]

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[118] Closing rates of a day. Dow Jones Industrial Average: October 9, 2007 – March 9 2009; Nasdaq: October 31, 2007 – March 9, 2009; DAX: July 16, 2007 – March 6, 2009; RTS: May 19, 2008 – January 23, 2009; Nikkei: July 9, 2007 – March 10, 2009; SSE Composite Index: October 16, 2007 – November 4, 2008; Sensex: December 12, 2007 – March 5, 2009.

[119] WEO Database, April 2010.

[120] IMF, *World Economic Outlook*, April 2010, p. 47.

Table 10. Annual growth of real GDP of OECD countries, countries considering access to the OECD and the remaining EC countries during the business cycle of 2001–2009, per cent.

	2001	2002	2003	2004	2005	2006	2007	2008	3Q08–3Q09	2009
OECD countries:										
Australia	3.8	3.2	4.1	2.8	3.1	3.8	3.7	1.1	0.9	*1.4*
Austria	0.5	1.6	0.8	2.5	2.5	3.6	3.7	2.2	−3.5	−3.9
Belgium	0.8	1.4	0.8	3.2	1.8	2.8	2.9	1.0	−2.7	−3.0
Canada	1.8	2.9	1.9	3.1	3.0	2.8	2.2	0.5	−3.1	−2.5
Czech Republic	2.5	1.9	3.6	4.5	6.3	6.8	6.1	2.5	−4.4	−4.1
Denmark	0.7	0.5	0.4	2.3	2.4	3.4	1.7	−0.9	−5.3	−4.9
Finland	2.3	1.8	2.0	4.1	2.9	4.4	5.3	0.9	−8.3	−8.0
France	1.9	1.0	1.1	2.5	1.9	2.2	2.4	0.2	−2.6	−2.6
Germany	1.2	0.0	−0.2	1.2	0.8	3.2	2.5	1.3	−4.8	−4.9
Greece	4.2	3.4	5.9	4.6	2.2	4.5	4.5	2.0	−2.5	−2.0
Hungary	4.1	4.4	4.3	4.9	3.5	4.0	1.0	0.6	−6.8	−6.3
Iceland	3.9	0.1	2.4	7.7	7.5	4.6	6.0	1.0	−10.9	−6.5
Ireland	5.7	6.5	4.4	4.6	6.2	5.4	6.0	−3.0	−7.7	−7.1
Italy	1.8	0.5	0.0	1.5	0.7	2.0	1.5	−1.3	−4.7	−5.0
Japan	0.2	0.3	1.4	2.7	1.9	2.0	2.4	−1.2	−4.9	*−5.2*
Korea	4.0	7.2	2.8	4.6	4.0	5.2	5.1	2.3	1.1	0.2
Luxembourg	2.5	4.1	1.5	4.4	5.4	5.6	6.5	0.0	−2.2	−4.1
Mexico	0.0	0.8	1.4	4.1	3.3	4.8	3.4	1.5	−6.2	*−6.6*
Netherlands	1.9	0.1	0.3	2.2	2.0	3.4	3.6	2.0	−4.1	−4.0
New Zealand	3.5	4.9	4.3	3.7	3.2	0.9	2.9	−1.4	−0.5	*−0.5*
Norway	2.0	1.5	1.0	3.9	2.7	2.3	2.7	1.8	−1.2	−1.6
Poland	1.2	1.4	3.9	5.3	3.6	6.2	6.8	5.0	1.4	1.7
Portugal	2.0	0.7	−0.9	1.6	0.8	1.4	2.4	0.0	−2.3	−2.6
Slovak Republic	3.5	4.6	4.8	5.0	6.7	8.5	10.6	6.2	−5.2	−4.7
Spain	3.6	2.7	3.1	3.3	3.6	4.0	3.6	0.9	−4.0	−3.6
Sweden	1.3	2.5	2.3	4.2	3.2	4.3	3.3	−0.4	−5.9	−5.1
Switzerland	1.2	0.4	−0.2	2.5	2.6	3.6	3.6	1.9	−1.4	*−1.5*
Turkey	−5.7	6.2	5.3	9.4	8.4	6.9	4.7	0.9	−3.3	−4.7
United Kingdom	2.5	2.1	2.8	3.0	2.2	2.9	2.6	0.5	−5.3	−4.9
United States	1.1	1.8	2.5	3.6	3.1	2.7	2.1	0.4	−2.7	*−2.4*
Euro Area	1.9	0.9	0.8	2.2	1.7	3.0	2.8	0.6	−4.1	−4.1
OECD Total	1.3	1.7	2.0	3.2	2.7	3.1	2.7	0.5	−3.4	*−3.3*
Countries negotiating on OECD membership:										
Chile	3.3	2.2	4.0	6.0	5.6	4.6	4.6	3.7	−1.8	−1.5
Estonia	7.5	7.9	7.6	7.2	9.4	10.0	7.2	−3.6	−15.6	−14.1
Israel	0.0	−0.7	1.5	5.0	5.1	5.3	5.2	4.0	0.1	0.5
Russian Federation	5.1	4.7	7.3	7.2	6.4	7.7	8.1	5.6	−9.2	*−7.9*
Slovenia	2.8	4.0	2.8	4.3	4.5	5.8	6.8	3.5	−8.8	−7.8
EC countries not included above:										
Bulgaria	4.1	4.5	5.0	6.6	6.2	6.3	6.2	6.0	..	−5.0
Cyprus	4.0	2.1	1.9	4.2	3.9	4.1	5.1	3.6	..	−1.7
Latvia	8.0	6.5	7.2	8.7	10.6	12.2	10.0	−4.6	..	−18.0
Lithuania	6.7	6.9	10.2	7.4	7.8	7.8	9.8	2.8	..	−14.8
Malta	−1.6	2.6	−0.3	0.7	3.9	3.6	3.8	1.7	..	−1.5
Romania	5.7	5.1	5.2	8.5	4.2	7.9	6.3	7.3	..	−7.1

Sources: "Gross domestic product: GDP, US $, constant prices, constant PPPs, reference year 2000, millions", OECD.Stat (August 15, 2010); "Quarterly National Accounts. Gross domestic product – expenditure approach. Millions of US dollars, volume estimates, fixed PPPs, OECD reference year, annual levels, seasonally adjusted", OECD.Stat (August 15, 2010); *OECD Economic Outlook*, No. 87, Preliminary Version, May 2010; "Real GDP growth rate", Eurostat.

OECD.Stat is used primarily. *Figures given in italics*, missing in OECD.Stat thus far (August 15, 2010), are from *OECD Economic Outlook*, No. 87, Preliminary Version, May 2010 (non-EU countries) or Eurostat (non-OECD countries).

The crisis hit Europe worst, especially some East European transitional economies. In the Baltic countries, after the adjustment difficulties in the 1990s, there was vigorous economic growth during the 2000s, based on large-scale foreign direct investments (FDI) from Western Europe, especially from the Nordic countries. After Autum 2008 the GDPs fell, in Latvia by 18 per cent in 2009, in Estonia and Lithuania somewhat less. The situation was aggravated as citizens of the Baltic countries were heavily indebted by home loans from Swedish banks, especially Swedbank. Moreover, in most other East European transitional economies the slump was remarkable. Hungary, which was hit by a large-scale home-loans crisis, suffered a GDP loss of 7 per cent from the third quarter of 2008 to that of 2009. The Romanian GDP sank by 7 and the Bulgarian by 5 per cent in 2009. In many countries drastic currency depreciations placed the borrowers with foreign-currency loans in an untenable situation.[121] (Table 10.)

Within the Commonwealth of Independent States (CIS) the GDP sank in 2009 by 7 per cent on average, but in Ukraine and Armenia by even 15 and 14 per cent, respectively. Russia was hit relatively severely. The prices of the main export articles, oil and gas, fell drastically, causing exports to decline by more than a third in 2009. The Russian GDP sank by 8 per cent in 2009. The situation was aggravated by the indebtedness abroad of key Russian industries. However, Russia met the crisis from a strong financial position. There was no financial crisis. In the 2000s, after the failures of the 1990s, Russia experienced vigorous economic growth. Russia accumulated, with rising oil and gas prices, foreign-exchange reserves which by 2007 amounted to the equivalent of 476 billion US dollars. The foreign debt of the state was virtually repaid, melted down from a third to about 2 per cent of GDP. During the recent crisis foreign-exchange reserves continued to grow, albeit slowly. Thus, for the Russian people the recent crisis was considerably easier than the hardships of the 1990s.[122]

Iceland suffered a GDP loss of 11 per cent from the last quarter of 2008 to the third quarter of 2009. (Table 10.) But this was a modest setback compared with the debts which the banking adventure imposed on the tiny nation.

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[121] WEO Database, April 2010; Tiusanen & Karhu (2010), pp. 3–33.

[122] BOFIT Russia Statistics; Kononenko (2009), pp. 34–36; Sutela (2010), pp. 167–172.

Within the Euro Area, the GDP fell from the third quarter of 2008 to that of 2009 and in 2009 by 4 per cent. Among the advanced EU countries, Finland was hit worst, even though there was no financial crisis in the country. Finland is highly dependent on exports, and the exports consist mainly of high-tech engineering products, on one hand, and on paper, on the other, i.e. products highly sensitive to cyclical fluctuations in world demand. During a year, from the third quarter of 2008 to that of 2009 and in 2009, the Finnish GDP fell by 8 per cent. The fall in GDP was also sharp in Ireland, which from the 1980s onwards had grown vigorously, by more than 7 per cent over the same periods.

Compared with Europe, the United States, the generator of the troubles, came through the crisis with a modest GDP loss, under 3 per cent during a year. (American bankers can safely launch a new round.) Unemployment, however, rose higher in the US than in the advanced countries in general. Japan suffered a GDP loss above the OECD average. The Australian GDP even grew slightly, according to preliminary data by 1.4 per cent[123] in 2009. (Tables 2 and 10.)

The crisis hit mainly those countries which during the Cold War formed the political "West" and "East", while the former "Third World" appears to have mainly watched the difficulties of the traditional industrial countries. Asia, Latin America and Africa were gripped by crisis in Autumn 2008, but their economies were not involved in the financial crisis proper and they quickly rebounded. In spite of relatively favourable development, growth per capita, however, was also negative in most emerging and developing economies in 2009 (Table 4).

Asia, except for Japan, experienced virtually no economic collapse. Recovery began already during the first half of 2009.[124] A recession, if any, was confined to a slight decline in growth rates. In 2009, the Chinese GDP grew by "only" 8 per cent. The Indian figure was 6 per cent. The Asian economies seemingly managed to substitute domestic demand for exports. The Bombay (Mumbai) stock exchange even recovered by late 2009 to the 2007 level (Figure 2). (Table 2.)

123 *OECD Economic Outlook*, 87, Annex Table 1.

124 IMF, *World Economic Outlook*, October 2009, pp. 71–75.

In Latin America, recovery started during the second quarter of 2009. The combined GDP of the region sank by less than 2 per cent in 2009. In Mexico, however, the fall was almost 7 per cent. (Table 2.)

Also Africa was hit only modestly. Growth figures slowed down in 2009 but remained positive. The combined GDP of the whole continent grew in 2009 by almost 3 per cent and that of Sub-Saharan Africa by more than 2 per cent.[125] (Table 2.)

The IMF predicts (April 2010) a slow recovery for Europe and the CIS countries but vigorous growth for Developing Asia and above-average growth for Sub-Saharan Africa. During the next couple of years the world GDP is expected to grow at an annual rate of over 4 per cent. In the advanced countries the average growth rate will be over 2 and in the emerging and developing economies over 6 per cent. The growth in the emerging and developing economies also appears to be a self-sustaining process, based on domestic demand for domestic consumer goods, not fundamentally dependent on exports to the advanced countries. As usual, improvement in the employment situation lags behind the growth of production.[126]

According to the IMF, recovery is by no means assured. With the recession barely surmounted, the IMF is already warning against a possible new real-estate bubble, this time in Asia. Rising housing prices and the increase in liquidity in the region have been fed, for example, by the recent revival of international financial flows from the advanced economies to Asia and Latin America. According to the *Global Financial Stability Report*, April 2010, "history suggests that bubbles could form in the medium term" – apparently referring to the Latin American and Asian financial crises in the 1990s.[127]

Resulting global economic shifts

The crisis of 2008–2009 brought about a distinct shift in the regional distribution of world GDP. In 2009, Asia already produced 29 per cent of world GDP in terms of exchange rates and 37 per cent in terms of PPPs. At the same time, the shares of China and India of world GDP

[125] WEO Database, April 2010.

[126] IMF, *World Economic Outlook*, April 2010, pp. 1–9, 43–68.

[127] IMF, G*lobal Financial Stability Report*, April 2010, pp. 28–34, 28 (quat.).

were 9 and 2 per cent, respectively, in terms of exchange rates, and 13 and 5 per cent, respectively, in terms of PPPs. According to the April 2010 estimates of the IMF, the Chinese (incl. Hong Kong) GDP already seems to have slightly bypassed that of Japan even in terms of exchange rates, thus making China the second largest economy in the world; and if not yet in 2009 then in 2010 at the latest. At the same time, the shares of North America and the United States declined to 27 and 25 per cent, respectively, in terms of exchange rates, and to 22 and 20 per cent, respectively, in terms of PPPs. The shares of Western Europe and the EU-15 declined to 28 and 26 per cent, respectively, in terms of exchange rates, and to 20 and 19 per cent, respectively, in terms of PPPs. (Table 3.)

Several circumstances suggest that growth rates in the emerging and developing economies will continue on high levels, while the advanced economies will grow relatively slowly in the near future, even apart from the general notion of the advantage of catching up with the more advanced countries. The crisis hit the advanced countries relatively hard, and historical records suggest lower growth rates in post-crisis situations (see p. 10). The necessity to reduce the high public-debt ratios (see pp. 94–95) will adversely affect aggregate demand. Finally, the growth impetus of the IT revolution may be exhausted. Given the predictions for future growth rates, the shift in the world economy to Asia and emerging economies in general will continue.

5. Prompt Stimulus, 2008–2009

National measures vs international action

The exceptional phenomenon of Autumn 2008 was the prompt anti-crisis action taken by governments and central banks all over the world, in international cooperation when needed. This was quite contrary to the failure during the Great Depression of the early 1930s and unprecedented even in more recent times. Both the monetary-policy toolkit of central banks and the fiscal policy means of governments were deployed to combat an imminent depression. Central banks cut down interest rates and, when the standard means of monetary policy were explored, established emergency facilities to increase liquidity. The EU and the West European countries hastily raised their deposit guarantees in Autumn 2008, even though the threat of bank runs was imminent in only few countries. For fiscal measures, governments launched large-scale stimulus packages to complement automatic stabilizers. For many countries bank support through fiscal means was of primary concern. Through decisive anti-crisis measures the imminent world-wide depression was shrunk to a relatively short-time recession lasting approximately a year. However, one must not be over-optimistic, since the Asian recovery involves a threat of over-heating and bold debt stimulus has led, as will be dealt with later on (pp. 93–95), to a threat of a new recession.

The recent crisis management shows that the idea of stimulus policies, known as Keynesianism, has become a generally recognized economic-policy doctrine. However, prompt action would not have been possible without the information basis of extensive statistical data on the economic situation, which has been compiled by national statistical offices and harmonized for international comparability by a number of international organizations since the Great Depression, notably after World War II.

When the financial crisis struck in Autumn 2008, the Group of Twenty (G-20) was able to organize prompt international action with the principle "the global crisis requires global solutions"[128]. Since

[128] "G-20 Communiqué. Meeting of Ministers and Governors, São Paulo – Brazil, 8–9 November 2008" [2]; "[Leaders Statement:] The Global Plan for Recovery and Reform, 2 April 2009" [2].

Autumn 2008 the G-20 has acted as a kind of "world government" albeit with limited terms of reference, even though officially it has no power of decision. The G-20 meetings defined guide-lines for anti-crisis policies and gave planning assignments to international organizations and standard-setting bodies. The participating states, of course, are pursuing their national interest as before. It was obviously the common distress that made the representatives of competing national states act, to a great extent, like a single political entity. From Autumn 2008 to Autumn 2009 three rounds of G-20 meetings were arranged to address the emerging problems and to organize international cooperation to handle them. The preparatory finance ministers' and central bank governors' meetings and subsequent summit meetings were as follows:

- São Paulo, November 8-9, 2008, Ministers and Governors / Washington, November 15, 2008, Summit on Financial Markets and the World Economy;
- London, March 14, 2009, Ministers and Governors / London, April 2, 2009, Summit, under the motto "Stability, Growth, Jobs";
- London, September 4-5, 2009, Ministers and Governors / Pittsburgh, September 24-25, 2009, Summit.

Since then, so far, the finance ministers and central bank governors have convened three times[129]. The leaders have convened at a summit once, in Toronto, Canada, in June 2010.

The Washington Summit, November 2008, was recorded to convene "amid serious challenges to the world economy and financial markets"[130] and the London Summit, April 2009, amidst "a crisis which has deepened since we last met, which affects the lives of women, men, and children in every country"[131]. The Pittsburgh

[129] St. Andrews, Scotland, November 7, 2009; Washington D.C., April 23, 2010; and Busan, Korea, 5, June 2010.

[130] "Declaration. Summit on Financial Markets and the World Economy, November 15, 2008" [1].

[131] "[Leaders Statement:] The Global Plan for Recovery and Reform, 2 April 2009" [2].

Summit, September 2009, could already notice “a critical transition from crisis to recovery”[132].

The Washington Summit, November 2008, issued an Action Plan, containing the guidelines both for the actual crisis management and the long-term stability programme. The subsequent meetings reviewed the implementation of the Plan and complemented the programme. The tasks called immediate actions were to be prepared by the following meeting in Spring 2009. The April 2009 Summit set deadlines for the medium-term preparatory work, expiring during 2009–2010.[133]

For the actual crisis management, the advanced economies and those emerging economies which were in a strong financial position could finance their public expenditure from resources of their own. On the other hand, international cooperation was needed to meet the needs of the poorest countries and of those countries worst hit by the crisis.

Monetary stimulus

Central banks responded to emerging liquidity problems within the banking system through expansionary monetary policies. Central banks first lowered their steering interest rates and other interest rates accordingly within the standard monetary-policy toolkit. In October 2008, a number of central banks, namely, the Federal Reserve System, the European Central Bank (ECB), the Bank of England, Sveriges Riksbank, the Swiss National Bank, and the Bank of Canada reduced their steering interest rates in a coordinated move.[134] Soon the steering interest rates were reduced further to a “zero rate”. The Fed set the target federal funds rate to 0–¼ per cent in December 2008. The ECB reduced the MRO rate to 1 per cent in May 2009. The Bank of England reduced the official bank rate to ½ per cent in March 2009.[135]

[132] “Leaders’ Statement: The Pittsburgh Summit. September 24–25, 2009” [Preamble: 1].

[133] “Declaration. Summit on Financial Markets and the World Economy, November 15, 2008” [10–11]; “Declaration on Strengthening the Financial System – London, 2 April 2009”.

[134] ECB, *Annual Report*, 2008, pp. 20.

[135] “Intended federal funds rate”, http://www.federalreserve.gov/fomc/fundsrate.htm; “Key ECB interest rates”, http://www.ecb.int/stats/monetary/; “Official Bank Rate History”, http://www.bankofengland.co.uk/ (March 23, 2010); Cf. Obstfeld & Rogoff (2009), pp. 16–17.

When interest-rate decisions turned out to be ineffective in the conditions of financial crisis, the central banks developed temporary non-standard methods to enhance liquidity. From December 2007 onwards, the Fed opened temporary special lending facilities[136] which extended the maturities of Fed loans and enlarged the range of eligible financial institutions, as well as securities acceptable as collateral. After the debacles of September 2008 the Fed opened a number of new lending facilities.[137] Additionally, the Fed has granted loans to a number of systemically important financial institutions outside the special programmes. The Fed also concluded currency swap agreements[138] with 14 foreign central banks. As a result of extraordinary credit expansion, the Fed's balance sheet expanded 2½-fold from $849 billion at the end of 2007 to $2.2 trillion at the end of 2009.[139]

Also the ECB developed a number of emergency arrangements to promote liquidity in the banking system. The most important change was that from October 2008 onwards the practice of a minimum bid rate for open-market operations was temporarily replaced by a fixed-rate tender procedure with full allotment. At the same time, maturities were extended and the list of eligible collateral was expanded. Commercial banks' demand for liquidity was thus fully satisfied at a low interest rate. Liquidity in foreign currencies was supported through swap agreements with the Fed and some European

[136] Term Auction Facility (TAF), introduced in December 2007; Primary Dealer Credit Facility (PDCF) and Term Securities Lending Facility (TSLF), introduced in March 2008.

[137] Money Market Investor Funding Facility (MMIFF), Commercial Paper Funding Facility (CPFF) and Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), introduced in October 2008 and expired/closed in October 2009, February 2010 and February 2010, respectively; Term Asset-Backed Securities Loan Facility (TALF), introduced in November 2008; Additionally, the Federal Deposit Insurance Corporation (FDIC) introduced in November 2008 the Temporary Liquidity Guarantee Program (TLGP).

[138] Expired on February 1, 2010; Through swap agreements the Fed lent dollars to and borrowed the equivalent in foreign currencies from foreign central banks.

[139] Lybeck (2009), pp. 119–122, 165–167; Shiller (2008), pp. 90–91; Akerlof & Shiller (2009), pp. 90–93; "The Crisis and the Policy Response"; Board of Governors of the Federal Reserve System, "Federal Reserve System Monthly Report on Credit and Liquidity Programs and the Balance Sheet", February 2010, http://www.federalreserve.gov/monetarypolicy/bst_reports.htm (March 24, 2010).

central banks. In May 2009, the ECB introduced new non-standard means to support liquidity, called the Enhanced Credit Support. Outright purchases of covered bonds was the most important new instrument. Covered bonds are securitized loans, but they differ from the American ABSs in that they remain in the issuing bank's balance sheet. Maturities were extended and the list of eligible collateral was expanded further. [140]

The most controversial emergency arrangement has been outright purchases of state-debt securities by central banks, which resembles the reprehensible practice of printing money. The Fed and the Bank of England resorted to this means in Spring 2009 and the ECB in the midst of the sovereign debt crisis of Spring 2010.

Fiscal stimulus

From September 2008 it was evident that the problems of the banking sector were not remediable through lending facilities to provide liquidity. At least the developments in Autumn 2008, the failure of Lehman Brothers being the most dramatic event, revealed that there was a large-scale insolvency crisis, which required urgent action to support the balance sheets of banks through budgetary means to prevent a general collapse of the banking system. The IMF estimates (April 2010) that from the start of the crisis in 2007 through 2010 the total sum of bank writedowns will amount to the equivalent of 2.3 trillion US dollars, of which 72 per cent are credit losses and 28 per cent depreciations of securities. The regional distribution would be as follows: the US – 39 per cent; the UK – 20 per cent; the Euro Area – 29 per cent; other Western Europe – 7 per cent; and Asia – 5 per cent.[141]

In September 2008 the Bush administration prepared a "bailout" plan of $700 billion, called the Troubled Asset Relief Program (TARP), to rescue the US banking system. The programme was first rejected by

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[140] *Economic Crisis in Europe* (2009), p. 62–66; ECB, *Annual Report*, 2008, pp. 98–109; ECB, *Annual Report*, 2009, pp. 16–22; "The ECB's enhanced credit support. Keynote address by Jean-Claude Trichet, President of the ECB at the University of Munich", Munich, 13 July 2009, http://www.ecb.int/press/key/date/2009/html/sp090713.en.html (March 24, 2010).

[141] IMF, *Global Financial Stability Report*, April 2010, pp. 11–14.

the House of Representatives, which triggered a world-wide panic, but eventually, in early October, it was approved, albeit only for half the amount, $350 billion for the time being, while approval of the second half was postponed for future consideration. The remaining $350 billion was then approved in January 2009. The original purpose of the TARP was, as indicated by the name, to buy up mortgage-related securities from financial institutions. By the time of implementation, however, the purpose had already changed to mainly recapitalization of financial institutions. At least one reason was the difficulty to establish a correct price for the impaired assets. All major and a large number of minor banks received funding through the TARP.

The US Government, neither the Bush nor the Obama administration, ever intended to establish a practice of state-banking. As maintained by Obama's election campaign, the banks had to buy themselves off from governmental support and return the American tax-payers their money. Therefore, recapitalization was not carried out as a subscription to common stocks but as hybrid loans called preferred shares. The preferred shares did not include voting rights but, instead, they yielded returns at a high interest rate – an efficient incentive for the banks to buy them off as soon as possible. The authorization for transforming preferred shares to common shares was realized only with regard to Citigroup.[142]

Liquidity support alone did not suffice in Europe either but most EU countries had to develop bank support to resume the solvency of the banking sector. The largest portion of governmental budgetary commitments, however, has consisted of guarantees for the banks' liabilities. In Western Europe, recapitalization of banks has taken place, to a large extent, on the basis of state ownership, mainly partial ownership, of equity capital proper. Nor, however, are the West European governments aiming to perpetuate state-banking.[143]

Apart from bank support and the effect of automatic stabilizers, governments all over the world announced stimulus packages to promote employment and production. Also support to some manufacturing and related industries, notably the car industry,

[142] Lybeck (2009), pp. 32–34, 119, 131–132, 165–167.

[143] Lybeck (2009), pp. 122–124, 160–165; *Economic Crisis in Europe* (2009), pp. 62–64; ECB, *Annual Report*, 2009, pp. 74–76.

has been of special concern in governmental policies in many countries.

In Western Europe, high social security alone forms an automatic stabilizer as public expenditure expands and public revenue contracts during a downward cycle. Public expenditure has been increased further by discretionary stimulus programmes. In late 2008 the EU approved a European Economic Recovery Programme (EERP) of €200 billion, within which the Commission has coordinated national and Community stimulus measures. According to a European Commission estimate, discretionary measures implemented in 2009 amounted to 1.3 per cent of GDP.[144]

In November 2008, the Chinese government announced a massive two-year stimulus package to substitute domestic demand for declining exports, while at the same time monetary policy was also relaxed. The package amounted to 4 trillion yuan (585 billion US dollars), of which about 1.2 trillion was allocated to the central government and the rest to local government and state enterprises. The programme was targeted to finance, in the first place, construction of infrastructure such as railways, roads, airports etc., but part of the appropriation was to be used for social, cultural, energy, environmental etc. purposes. The programme had a greater effect than expected, causing even a threat of overheating of the Chinese economy. Yet, compared with the advanced countries, the relative scale of fiscal stimulus remained relatively modest. Government deficit is reported to have remained at 2.8 per cent of GDP in 2009.[145]

Russia had a reserve fund at its disposal when the crisis struck. The Stabilization Fund was established in 2004 to gather reserves from export duty and production tax on oil. In February 2008, the Fund was split into a Reserve Fund to ensure financing of the federal budget and a National Welfare Fund to support the Russian pension system. The former was allocated 3 058 billion rubles (125 billion US dollars) and the latter 783 billion roubles (32 billion US dollars). The revenue basis was enlarged to an export duty and a production tax on gas. As a result of the recession, the capital of the Reserve Fund has

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[144] *Economic Crisis in Europe* (2009), pp. 67–69; ECB, *Annual Report*, 2009, p. 76.

[145] "China's pro-active fiscal policy and moderately loose monetary policy", http://english.gov.cn/(April 20, 2010); BOFIT China Statistics (April 20, 2010).

melted from 3 505 billion rubles (143 billion US dollars) in September 2008 to 1 553 billion rubles (53 billion US dollars) in April 2010.[146] In Russia, however, debt stimulus remained relatively modest. The federal government deficit amounted to 6 per cent of GDP in 2009, but this is counterweighted by accumulated surpluses during the preceding years.[147]

The increase in public deficits and public debt can be regarded as a proxy for the sizing of stimulus, including bank support. General government net borrowing of 33 advanced economies formed 1.1 per cent of GDP in 2007, but rose to 3.6 per cent in 2008 and to 8.7 per cent in 2009.[148] The combined central government debt of the 30 OECD countries grew by 3.7 per cent in 2008, but by more than 17 per cent in 2009.[149]

Concerted action by G-20, 2008–2009

The G-20 meetings made a number of decisions on the global economy. In the short run, the G-20 action strove to restore confidence and to turn the world economy from crisis back to the pre-crisis growth path. In the long run, the goal was even more ambitious, to reform the global financial system to prevent similar crises emerging in the future.[150]

The finance ministers' and central bank governors' meeting in November 2008 defined as the immediate task "to mitigate the impact of the crisis on global economy through comprehensive, coordinated and timely measures".[151] The most immediate task in Autumn 2008 and Spring 2009 was to restore credit after "a profound lack of confidence"

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[146] "About the Fund"; "Aggregate amount of the Stabilization Fund of the Russian Federation"; "Reserve Fund"; "National Wealth Fund"; "Aggregate amount of the Reserve fund", http://www.minfin.ru (April 20, 2010).

[147] BOFIT Russia Statistics (April 20, 2010).

[148] WEO Database, April 2010.

[149] See sources to Table 7.

[150] See, e.g. "Declaration. Summit on Financial Markets and the World Economy, November 15, 2008" [1–2]; "[Leaders Statement:] The Global Plan for Recovery and Reform, 2 April 2009" [4].

[151] "G-20 Communiqué. Meeting of Ministers and Governors, São Paulo – Brazil, 8–9 November 2008" [4].

had led to severe credit constraints, which affected consumption, investment and employment. The G-20 meetings could record measures taken thus far in many countries to cut down interest rates, to support liquidity, to recapitalize financial institutions, to reinforce deposit protection and to stimulate demand.[152] The March–April 2009 meetings expressed praise especially for the measures carried out for bank recapitalization and dealing with impaired assets. The G-20 meetings, however, warned against moral hazard. The finance ministers and central bank governors pointed out: "Government support is a privilege and must come with strong conditions (...)". They confirmed the principles to be applied to government support, the most important being that risk transfer should be "at a fair price", that the banks' shareholders were required "to contribute to the maximum extent possible to loss or risk coverage prior to government intervention", that government support was to be conditioned and monitored, and that it had to be temporary.[153]

The cause of the developing countries has been highlighted in the G-20 statements since 2008. The November 2008 Summit declared its preparedness to "[h]elp emerging and developing economies gain access to finance in current difficult financial conditions". The G-20 resorted especially to the IMF and the World Bank and other multilateral development banks (MDBs) as agents to implement the decisions; their resources were to be increased urgently.[154] The March 2009 finance ministers' and central bank governors' meeting listed the financing needs: countercyclical spending, bank recapitalization, infrastructure, trade finance, rollover risk and social support.[155]

[152] "G-20 Communiqué. Meeting of Ministers and Governors, São Paulo – Brazil, 8–9 November 2008" [4–5, 7]; "Declaration. Summit on Financial Markets and the World Economy, November 15, 2008" [1]; "United Kingdom, 14 March 2009. Restoring lending: a framework for financial repair and recovery".

[153] "G-20 Communiqué. Meeting of Finance Ministers and Central Bank Governors, United Kingdom, 14 March 2009" [2–4]; "G-20 Communiqué Annex. Meeting of Finance Ministers and Central Bank Governors, United Kingdom, 14 March 2009. Restoring lending: a framework for financial repair and recovery" [4–11].

[154] "Declaration. Summit on Financial Markets and the World Economy, November 15, 2008" [7, 14].

[155] "G-20 Communiqué. Meeting of Finance Ministers and Central Bank Governors, United Kingdom, 14 March 2009" [5].

For the actual crisis management, the G-20 meetings mainly "welcomed" the anti-crisis measures taken in the rich and financially strong countries, while the common G-20 effort focused on developing and financially weak countries. The G-20 urged and coordinated, in cooperation with the IMF, the World Bank and other international financial institutions (IFIs), the international raising of funds to support these countries. The March-April 2009 meetings recorded funds arranged, a programme of 1.1 trillion US dollars "to restore credit, growth and jobs in the world economy". The contributions were as follows: 500 billion dollars of new resources available to the IMF in the framework of New Arrangements to Borrow (NAB), 250 billion dollars of new SDR allocations (the final amount was to be 283 billion dollars, of which more than 100 billion were intended for emerging market and developing countries[156]), "at least" 100 billion of additional lending by the MDBs, 250 billion of support for trade finance, and 6 billion for the poorest countries from sales of IMF gold. Most G-20 members – including, e.g. China, India, Brazil and Russia – and some non-G-20 countries committed themselves to raising funds. The IMF established a new concessional – i.e. at a subsidized interest rate – facility for lending to the poorest countries. "Taken together," the G-20 leaders stated, "these actions will constitute the largest fiscal and monetary stimulus and the most comprehensive support programme for the financial sector in modern times."[157] The Pittsburgh Summit, September 2009, could state that raising the funds had proceeded successfully.[158]

The IMF's resources were augmented according to the G-20 decisions. The IMF increased its lending to poor, financially strained countries. In the framework of Stand-Up Facilities, i.e. conventional quota-based lending, a new Flexible Credit Line (FCL) was created, available for countries with strong economic fundamentals and to which traditional conditionality is not applied. During the financial

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[156] "Leaders' Statement: The Pittsburgh Summit. September 24-25, 2009" [19].

[157] "[Leaders Statement:] The Global Plan for Recovery and Reform, 2 April 2009" [5]; "Declaration on Delivering Resources through the International Financial Institutions – London, 2 April 2009"; The NAB funds raising by the IMF brought in 501,3 billion US dollars. "Bolstering the IMF's Lending Capacity", Last Updated: March 12, 2010, http://www.imf.org/external/np/exr/faq/contribution.htm (March 29, 2010).

[158] "Leaders' statement, the Pittsburgh Summit, 25 September 2009" [19].

year 2009 the IMF lent SDR 65.8 billion to 15 countries in Asia (Mongolia, Pakistan), Africa (Seychelles), Latin America (Costa Rica, El Salvador, Guatemala, Mexico), the Commonwealth of Independent States (Armenia, Belarus, Georgia, Ukraine), Eastern Europe (Hungary, Latvia, Serbia) and Western Europe (Iceland). Almost half, i.e. SDR 31.5 billion was allocated to Mexico, the only country within the FCL. Ukraine was allocated SDR 11 billion and Hungary SDR 10.5 billion. Within the special facilities for poorest countries, the Poverty Reduction and Growth Facility (PRGF) and the Exogenous Shock Facility (ESF), the IMF allocated SDR 1.1 billion mainly to African countries. Since then Poland has been allocated SDR 13.7 billion and Colombia SDR 7 billion within the FCL.[159]

Committed to promote trade liberalization, the G-20 definitely condemned all kinds of protectionism, even as crisis policy, "whether in respect of trade or investment"[160]. In the November 2008 Summit the G-20 countries pledged for the next 12 months to "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".[161] The London Summit, April 2009, observed that world trade, the growth of which had "underpinned rising prosperity for half a century", was now falling for the first time in 25 years. The Summit extended the non-protectionism pledge to the end of 2010. The G-20 countries would "notify promptly" the WTO of any violation of the decision.[162] The London summit also, in order to "conduct all our economic policies cooperatively and responsibly with regard to the impact on other countries", pledged to "refrain from competitive devaluation of our currencies and promote a stable and well-functioning international monetary system". [163] The Toronto Summit, June 2010, extended the non-protectionism pledge until the end of 2013.[164]

[159] IMF, Annual Report 2009, pp. 10–11, 27–32, 35.

[160] "G-20 Communiqué. Meeting of Ministers and Governors, São Paulo – Brazil, 8–9 November 2008" [7].

[161] "Declaration. Summit on Financial Markets and the World Economy, November 15, 2008" [13].

[162] "[Leaders Statement:] The Global Plan for Recovery and Reform, 2 April 2009" [22].

[163] "[Leaders Statement:] The Global Plan for Recovery and Reform, 2 April 2009" [12].

[164] "The G-20 Toronto Summit Declaration, June 26–27, 2010" [36].

By and large, the G-20 countries managed to keep the non-protectionism pledge with regard to foreign trade in its narrow meaning. Complaints to the WTO's Dispute Settlement Body did not increase in a discernible way[165]. For rich countries, it is relatively easy to lend, to some extent even to donate money to poor countries. What is delicate are measures related to the competitiveness of domestic industries vis-à-vis other countries. Thus, the industrial policy measures to save jobs, especially within the car industry, as well as public procurement have, in fact, favoured domestic-located plants. There have been "Buy American" campaigns etc., but, for example, the existence of the European Union and the European Economic Area has contained protectionism within Europe. The main international trade dispute seems to be between the United States and China on the Chinese exchange rate. The crisis of 2008–2009 has heightened complaints within the US that China is maintaining an artificially low exchange rate on the yuan to promote exports, thus aggravating the US balance-of-payments deficits. Russia, not a member of the WTO and thus not committed to the WTO trade rules, has improvised various obstacles to food imports from the EU.

From the September 2009 meetings onwards, the G-20 was already oriented to seek an exit strategy. The Summit warned against "premature withdrawal of stimulus" but at the same time it notified that "we will prepare our exit strategies and, when the time is right, withdraw our extraordinary policy support in a cooperative and coordinated way". The Summit pointed out the need to shift from public to private demand as the vehicle of growth.[166] The finance ministers' and central bank governors' meeting, convened in November 2009 "at a critical point in the recovery from the crisis", as well as the 2010 meetings, still regarded it necessary to continue stimulus policies until recovery is assured. Choices between stimulus and exit are being made in a controversial situation. On one hand, it is considered that the economic situation still necessitates stimulus

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165 "Chronological list of disputes cases", http://www.wto.org/english/tratop_E/dispu_e/dispu_status_e.htm (March 29, 2010).

166 "G-20 Communiqué. Meeting of Finance Ministers and Central Bank Governors, London, 4–5 September 2009" [4]; "Leaders' statement, the Pittsburgh Summit, 25 September 2009" [Preamble: 10, 14; 2].

in 2010 but, on the other hand, because of excessive public debt many countries cannot really afford more stimulus policies.[167]

The IMF reports, October 2009, still suggested continued stimulus policies "until the recovery is on a firmer footing".[168] The April 2010 reports were already oriented more to warning against new threats, especially those related to public debt and possible new asset bubbles. Governments had to prepare credible medium-term fiscal consolidations plans. According to the IMF, the fiscal stimulus planned for 2010 is to be implemented but, in most of the advanced economies, fiscal consolidation is to be started in 2011 and, in countries with high public debt-related risks, immediately.[169]

New problem: sovereign risk

Fiscal stimulus led to excessive public debt since, as stated above, the initial debt levels were high in many countries. Many advanced countries – as a rule, not the emerging nor developing economies – had accumulated large public debts already prior to the crisis, during the economic boom, because it was more convenient for politicians thinking of their constituents to resort to debt financing rather than raising taxes. As a result of debt stimulus, in many advanced countries, public debt has risen since Autumn 2008 to levels which are apparently unsustainable. The April 2010 reports of the IMF speak about a sovereign risk, which even threatens to nullify the recovery achieved thus far and plunge the world economy back into crisis. According to the *World Economic Outlook* (April 2010), the stimulus policies had "all but eliminated the risk of a second Great Depression" and "room for policy manoeuvres in many advanced economies has

[167] "G-20 Communiqué. Meeting of Finance Ministers and Central Bank Governors, United Kingdom, 7 November, 2009" [1–2].

[168] Olivier Blanchard & José Viñals, "Joint Foreword to *World Economic Outlook* and *Global Financial Stability Report*", in: IMF, *World Economic Outlook*, October 2009, pp. x–xiii.

[169] Olivier Blanchard & José Viñals, "Joint Foreword to *World Economic Outlook* and *Global Financial Stability Report*" and "IMF Executive Board Discussion of the Outlook, April 2010", in: IMF, *World Economic Outlook*, April 2010, pp. xii–xiii, 139–140.

either been largely exhausted or has become much more limited, leaving these fragile recoveries exposed to new shocks".[170]

In 2008 and 2009, the US public, federal and general government deficit rose to 6–7 and 11 per cent of GDP, respectively. Consequently, the US federal government debt rose to 40 and 53 and the total public (general government) debt to 70 and 83 per cent of GDP, respectively.

The Japanese central government deficit amounted to 2.6 per cent of GDP in 2008 and 5.8 per cent of GDP in 2009. At the moment, the Japanese public debt has risen to record levels, the central government debt amounting to 184 and the total public (general government) debt to 193 per cent of GDP in 2009. (Tables 6–9.)

The IMF experts were concerned about developments in many countries of the European Union and the Euro Area.[171] In 2009, the general government deficit of the member countries of the European Union and the Euro Area was on average 6.8 and 6.3 per cent of GDP, respectively. The total (general government) debt of the Euro Area rose to 79 per cent of GDP.

Among the euro countries, the most notorious sovereign risk country is Greece, that managed to join the Euro Area in 2001 by presenting delusive statistical data of its economic state. The risk exposed by Greece materialized in April 2010. According to the official Eurostat figures, in 2009, the Greek general government deficit and debt rose to 14 and 115 per cent of GDP, respectively, but, according to Eurostat, after recalculation the public debt may rise to 120–122 per cent of GDP[172]. (Tables 6–9.) In late April, 2010, the rating agency Standard & Poor's downgraded Greece's long-term debt to BB+, i.e. "junk".[173] In 2009, the Italian public (general government) debt rose to 116 per cent of GDP. During the crisis the public debt of Portugal, Spain and Ireland, which formerly were not alarmingly indebted, rose rapidly. In 2009 their public (general government) deficits were

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[170] IMF, *World Economic Outlook*, April 2010, pp. 5 (quat.), 11–13, 11 (quat.); IMF, *Global Financial Stability Report*, April 2010, pp. xii–xv, 3–10.

[171] IMF, *World Economic Outlook*, April 2010, pp. 6–9.

[172] "Eurostat. News release. Euro indicators 55/2010 – 22 April 2010", http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/introduction.

[173] "Sovereign Ratings And Country T&C Assessments As Of April 28, 2010", http://www.standardandpoors.com/

9, 11 and 14 per cent, while the public (general government) debt amounted to 77, 53 and 64 per cent, respectively, of GDP. All three countries' state debt has been downgraded since Spring 2010, albeit not as drastically as that of Greece. The Belgian general government debt rose to 97 per cent of GDP in 2009, but it has not evoked special international concern. By 2009, the public debt of almost all Euro Area countries had exceeded the reference value of 60 per cent relative to GDP, while that of Hungary had also increased. In 2009, within the Euro Area only Luxembourg and Finland kept within the EMU reference values. (Tables 6–9.)

Public debts will grow further during the next few years, even though it is expected to take place at a slowing pace. The Toronto Summit of the G-20, June 2010, recorded a commitment of the advanced countries to at least halve the public deficits by 2013 and to stabilize or reduce the ratio of public debt to GDP by 2016.[174] It will, thus, be a long time before financial preparedness to meet a new severe economic crisis is restored.

Reluctantly, but in view of the fact that the creditworthiness of the whole Euro Area was at stake, the other euro countries, together with the IMF, in April–May 2010 compiled a three-year rescue programme for Greece consisting of a €110 billion loan with strict conditionality.[175] With regard to the other problematic countries, in May 2010 the EU established a European Stabilization Mechanism consisting of two arrangements, a €60 billion lending facility under the European Commission and a €440 billion special purpose vehicle, named the European Financial Stability Facility, financed by the Euro Area countries. The complementary IMF participation, expected to be one third, raises the amount to €750 billion. Loans within the arrangement are subject to strong conditionality according to the IMF rules.[176]

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[174] "The G-20 Toronto Summit Declaration, June 26–27, 2010" [10].

[175] "Joint Statement on Greece by EU Commissioner Olli Rehn and IMF Managing Director Dominique Strauss-Kahn", Press Release No.10/177 – May 2, 2010, http://www.imf.org/

[176] "The European Stabilization Mechanism", MEMO/10/173, Brussels, 10 May 2010, http://ec.europa.eu/ (June 30, 2010); Statement by EU Finance Ministers on Setting Up Stabilization Fund: Text, http://www.bloomberg.com/, (June 30, 2010); Davies & Gyntelberg, (2010), pp. 8–9.

As a result of the sovereign risk revealed within the Euro Area, the floating exchange rate of the euro fell considerably in Spring 2010. This gave the Euro Area a certain price-competitiveness advantage, without violating the non-devaluation pledge of the G-20, which will probably counter-affect to some extent the otherwise poor growth prospects of Europe.

6. G-20 Design for Global Financial Stability

The tranquil years of G-20, 1999–2007

During 1999–2007 the finance ministers and central bank governors of the Group of Twenty convened once a year to address the problems of the world economy. The supreme goal, as maintained by all G-20 meetings, was "stable and sustained" economic growth, backed by a stable international financial system. With the financial crises of the 1990s in mind, the G-20 strove to prevent new crises emerging. For this purpose the G-20 strove, in the first place, to establish so-called best practices. The G-20 view was recorded, for example, in the two programme documents "Reducing Vulnerability to Financial Crises" (2000) and "G-20 Accord for Sustained Growth" (2004). Recommendations were formulated in vague wording to be accepted unanimously by all the twenty parties. The G-20 resolutions from these years prove that the financial experts of the world were aware of the problems which threatened global stability but obviously they did not expect such a slump which then occurred in 2008.

As dealt with above in Chapter 3, the main global imbalances of recent years have been the huge balance-of-payments deficits and the public debt of notably the United States but also of a number of other OECD countries. For the US external balance, one grievance has been the exchange rates of the Japanese yen and the Chinese yuan to the US dollar. In the US view, Japan and China have undervalued their currencies to promote their exports to the US market and have thus aggravated the US external position. "Correct" exchange rates, which would satisfy all parties, have not been found. The Montreal meeting (2000) of the G-20 reached a vaguely formulated stance, reflecting the wide range of national practices. It embraced a wide range of exchange rate regimes from floating to firm fixing, provided they were "supported (...) by appropriate macroeconomic policies and by sound financial institutions". In the last instance, the G-20 trusted the surveillance of the IMF. The 2004 Accord warned against excessive borrowing in foreign currencies for domestic activities – a reference to the Latin American and Asian crises in the 1990s. The "G-

20 Reform Agenda" (2004) included a number of promises made by individual G-20 countries. For example, the United States promised to encourage savings to mitigate its balance-of-payments problems: this did not materialize (see Table 5).

For the public debt, the 2000 programme demanded a "prudent liability management" without setting exact guide-lines. The 2004 Accord demanded fiscal discipline. Public expenditure and public debt were to remain "at reasonable levels in relation to national aggregates [in the first instance, GDP – TP]". The United States, indeed, subsequently managed to reduce its budget deficit temporarily before the financial crisis of 2008–2009, even though the performance remained modest (see Table 6).

The G-20 decisions highlighted the importance of international standards and codes for the financial market. The finance ministers and central bank governors of the G-20, as well as their economic experts, apparently trusted the Basel standards which were even complemented in the 2000s. The point was the observance of common rules. The inaugural Berlin meeting (1999) urged the governments to complete the Financial Sector Assessment Programs (FSAPs) and the Reports on Observance of Standards and Codes (ROSCs), initiated by the IMF and the World Bank. The Montreal meeting (2000) urged the governments to publicly articulate their commitment to adopt the key standards and codes. Of special concern was to avoid defaults by private debtors. The G-20 referred especially to the Financial Stability Forum (FSF) as the main standard-setting body and to the IMF as the main surveillant. The International Monetary and Financial Committee (IMFC) of the IMF was urged to continue developing a framework for financial stability.[177]

[177] "Meeting of G-20 Finance Ministers and Central Bank Governors, Berlin, December 15–16, 1999. Communiqué"; "Meeting of G-20 Finance Ministers and Central Bank Governors, Montréal, October 25, 2000. Communiqué"; "Annex. Reducing Vulnerability for Financial Crises"; "G-20 Communiqué. Meeting of Finance Ministers and Central Bank Governors, Berlin, 20–21 November 2004"; "G-20 Accord for Sustained Growth. Stability, Competition and Empowerment: Mobilizing Economic Forces for Satisfactory Long-Term Growth", Berlin, 21 November 2004; "G-20 Reform Agenda. Agreed actions to implement the G-20 Accord for Sustained Growth", Berlin, 21 November 2004.

The G-20 has from the very beginning been committed to economic globalization, taking the view that liberal practices best ensure efficient use of capital and thus promote world-wide economic growth and prosperity. In this view, globalization is the main means to foster economic development in the poor countries. The Montreal meeting (2000) praised globalization as "an enormously powerful force contributing to improving the lives of hundreds of millions of people". The G-20 has supported liberalization of international capital movements, while the terms of reference of the IMF are confined to payments on international trade with goods and services. With the Latin American and Asian financial crises of the 1990s in mind, it was, however, pointed out that liberalization was to proceed prudently in order to avoid excessive volatility in capital movements. The G-20 Accord (2004) stated that liberalization of capital account necessitates increasing the degree of exchange rate flexibility accordingly.[178] After the Doha negotiations round of the World Trade Organization (WTO) was inaugurated in November 2001, each G-20 meeting reiterated its support for successful completion of the negotiations. The 2005 meeting deemed that the negotiations should be concluded by the end of 2006.[179] However, national interests appear to clash strongly with each other since a solution has still today (September 2010) not been attained.

The G-20 has highlighted the cause of the developing countries and emerging economies. The 2002 meeting declared commitment to the Millenium Development Goals of the United Nations, defined in 2000–2002, to reduce world poverty and poverty-related diseases.[180] The "G-20 Accord for Sustained Growth" (2004) regarded empowering people in the developing countries essential to promote economic growth and abolish poverty. The first issue was high-quality primary

[178] "Meeting of G-20 Finance Ministers and Central Bank Governors, Montréal, October 25, 2000. Communiqué"; "G-20 Accord for Sustained Growth. Stability, Competition and Empowerment: Mobilizing Economic Forces for Satisfactory Long-Term Growth", Berlin, 21 November 2004.

[179] "Meeting of G-20 Finance Ministers and Central Bank Governors, Ottawa, November 17, 2001. Communiqué", and subsequent meetings; "G-20 Communiqué. Meeting of Finance Ministers and Central Bank Governors, Xianghe, Hebei, China, October 15–16, 2005" [4].

[180] "G-20 Finance Ministers' and Central Bank Governors' Meeting, Delhi Communiqué, November 23, 2002" [8].

and secondary education, which would also promote good governance and sound institutions. The second was promoting entrepreneurship, which would also integrate people with the formal economy. The third was social infrastructure, including social safety-nets to mitigate the effects of unemployment, as well as clean water, sanitation and health services which are necessary for welfare and economic growth. The G-20 urged policy-makers but especially those of the emerging and developing economies to "design social policies so as to permit market mechanisms to function effectively".[181] The 2005 meeting expressed its support of the UN target for development assistance, 0.7 per cent of gross national product (GNP)[182], but stated two paragraphs later that "trade liberalization and integration are key drivers of economic growth and the reduction of poverty".[183] From 2005 onwards, the G-20 has urged the reform of the Bretton Woods organizations.[184]

Combating criminal and illicit activities, notably money laundering and tax evasion but also corruption, has belonged to the G-20 agenda from the very beginning. For the liquidation of the so-called tax havens, the 2004 meeting issued, in accordance with the "Model Agreement on Exchange of Information on Tax Matters" of the OECD (2002), a "G20 Statement on Transparency and Exchange of Information for Tax Purposes". The G-20 pointed out that international investment decisions were to be based on "legitimate commercial considerations rather than the circumvention of tax laws". From Autumn 2001 onwards, after the September 11 attacks, combating terrorism came onto the G-20 agenda. The G-20 paid special attention to the financing of terrorism. The Ottawa meeting, November 2001, issued a "G-20 Action Plan on Terrorist Financing" to freeze terrorist assets and to close terrorists' access to the international financial system. The G-20 resorted particularly to the Financial Action Task Force on Money Laundering (FATF), established by the G-7 in 1989.[185]

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[181] "G-20 Accord for Sustained Growth. Stability, Competition and Empowerment: Mobilizing Economic Forces for Satisfactory Long-Term Growth", Berlin, 21 November 2004.

[182] As distinct from the GDP, the GNP includes net income transfers from abroad.

[183] "The G-20 Statement on Global Development Issues" (2005) [4, 6].

[184] "The G-20 Statement on Reforming the Bretton Woods Institutions" (2005), and subsequent years' communiqués.

[185] "Meeting of G-20 Finance Ministers and Central Bank Governors, Ottawa, November 17, 2001. Communiqué"; incl. "G-20 Action Plan on Terrorist Financing".

Regulation in the global market economy

As stated above, financial experts were aware of the threats to international financial stability, even though only few truly believed they would materialize. On this basis, the G-20 was prepared for prompt action, both with regard to immediate stimulus measures and with regard to long-term planning.

The G-20 programme for global financial stability in the long run was based on an analysis of the causes of the 2008-2009 crisis which can be summed up – in line with the economists referred to above – as follows:

1. The proximate cause of the crisis was excessive risk taking by financial institutions to enhance profits; one of the most important factors was bank directors' greed for bonuses.
2. Excessive risk taking was enabled by deficiencies of regulation, accounting and supervision.
3. Macroeconomic policies preceding the crisis exacerbated imbalances, which contributed to the crisis.

Both the finance ministers and central bank governors and the leaders of the G-20 regarded the crisis as a result of irresponsible proceedings by financial institutions, especially excessive risk taking to enhance lending, combined with inadequate action by regulatory and supervisory authorities. The Washington Summit, November 2008, condemned the proceedings of the financial-market actors as follows:[186]

> "(...) 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

[186] "Declaration. Summit on Financial Markets and the World Economy, November 15, 2008" [3]; cf. "G-20 Communiqué. Meeting of Ministers and Governors, São Paulo – Brazil, 8-9 November 2008" [3].

> countries, did not adequately appreciate and address the risks building up in financial markets (...)"

The "some advanced countries" obviously referred to the United States, at least in the first place.

The G-20 leaders also criticized their own governments' previous macroeconomic policies as an underlying factor in the crisis: "(...) inconsistent and insufficiently coordinated macroeconomic policies, inadequate structural reforms (...) contributed to excesses and ultimately resulted in severe market disruption."[187]

The ambitious goal of the G-20 was to ensure that "a global crisis, such as this one, does not happen again". The G-20 programme work in 2008-2009 focused on creating a new global financial order which would combine effective financial regulation with the principles of the global market economy. "We will take action", the London Summit of April 2009 declared,[188]

> "to build a stronger, more globally consistent, supervisory and regulatory framework for the future financial sector, which will support sustainable global growth and serve the needs of business and citizens."

The Summit spoke about "an inclusive, green, and sustainable recovery"[189]. The Pittsburgh Summit, September 2009, introduced the designation "Framework for Strong, Sustainable and Balanced Growth" for the long-term G-20 programme.[190] "Where reckless behavior and a lack of responsibility led to crisis," the Summit declared, "we will not allow a return to banking as usual."[191]

On the other hand, norms for other facets of economic governance than banking regulations were addressed only momentarily and in vague wording by the G-20 meetings. In the first instance, the G-20 presumed the member countries would conduct "responsible

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187 "Declaration. Summit on Financial Markets and the World Economy, November 15, 2008" [4].

188 "[Leaders Statement:] The Global Plan for Recovery and Reform, 2 April 2009" [13].

189 "[Leaders Statement:] The Global Plan for Recovery and Reform, 2 April 2009" [4].

190 "Leaders' Statement: The Pittsburgh Summit. September 24-25, 2009".

191 "Leaders' Statement: The Pittsburgh Summit. September 24-25, 2009" [Preamble: 16].

fiscal policies" and "undertake monetary policies consistent with price stability". Some more specified requirements were promoting more balanced current accounts than the members had managed to perform thus far, as well as the commitment to open trade and investment and rejection of protectionism, i.e. commitment to the global market economy. The G-20 stance advocated "market oriented exchange rates that reflect underlying economic fundamentals" – a goal which is relatively easy to agree with on the theoretical level but the implementation of which is extremely prone to controversies. The Pittsburgh Summit urged the countries with chronic and large external deficits – refers especially to the United States – to promote private savings and fiscal consolidation, and the countries with sustained and large external surpluses – refers especially to China and other emerging economies in Asia – to strengthen domestic demand.[192] Recommendations on monetary, exchange-rate and fiscal policies were, however, by no means intended as binding norms. The G-20 stabilization programme is, thus, essentially confined to the rules in the financial market.

The November 2008 Summit urged the IMF, in close coordination with the Financial Stability Forum (FSF) and other bodies, to "take a leading role in drawing lessons from the current crisis".[193] The Autumn 2008 and Spring 2009 meetings urged the FSF, renamed the Financial Stability Board (FSB) in Spring 2009, in cooperation with the IMF, to develop a system of "early warning" to identify and report to the International Monetary and Financial Committee (IMFC) of the IMF and the G20 finance ministers and central bank governors on macroeconomic and financial risks, and to suggest action to address them.[194]

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[192] Spec. "Leaders' Statement: The Pittsburgh Summit. September 24–25, 2009" [G-20 Framework for Strong, Sustainable, and Balanced Growth: 1–2].

[193] "Declaration. Summit on Financial Markets and the World Economy, November 15, 2008" [Action Plan (...)].

[194] "G-20 Communiqué. Meeting of Ministers and Governors, São Paulo – Brazil, 8–9 November 2008" [14]; "Declaration. Summit on Financial Markets and the World Economy, November 15, 2008" [Action Plan (...)];"G-20 Communiqué. Meeting of Finance Ministers and Central Bank Governors, United Kingdom, 14 March 2009" [6]; "[Leaders Statement:] The Global Plan for Recovery and Reform, 2 April 2009".

The G-20 meetings of 2008–2009 assigned further planning to the FSF/FSB, the Basel Committee on Banking Supervision (BCBS) and a number of special standard-setting bodies, established on different occasions, including members from different countries. The International Organization of Securities Commissions (IOSCO)[195] was tasked to clear up questions related to securities and ratings. The International Association of Insurance Supervisors (IAIS)[196] has clarified regulation of the insurance branch. Apart from the FSF/FSB and the BCBS, the Committee on the Global Financial System (CGFS)[197] has been given the task of considering questions of capital requirements, notably the question of pro-cyclicality. The Committee on Payment and Settlement Systems (CPSS)[198] has studied the question of derivatives trade. The International Accounting Standards Board (IASB), an independent group of experts[199], has considered accounting standards, leaning, to a great extent, on a private US body, the Financial Accounting Standards Board (FASB)[200]. The International Federation of Accountants (IFAC)201 has considered the questions of audit. (See Table 11.)

The design for a new global financial system was drawn up substantially during the period from Autumn 2008 to September 2009. The Pittsburgh Summit, September 2009, could self-assess the work done as follows:[202]

> "Substantial progress has been made in strengthening prudential oversight, improving risk management, strengthening transparency, promoting market integrity, establishing supervisory colleges, and reinforcing international cooperation."

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[195] Former Inter-American Conference of Securities Commissions, established in 1974.

[196] Established in 1994.

[197] Former Euro-currency Standing Committee, established in 1971.

[198] Established in 1980 by the G-10 central bank governors as the Group of Experts on Payment Systems.

[199] Founded in 2001, successor of the International Accounting Standards Committee (IASC), founded in 1973.

[200] Created in 1973.

[201] Established in 1977.

[202] "Leaders' Statement: The Pittsburgh Summit. September 24–25, 2009" [11].

Table 11. G-20 assignments to international organizations and standard-setting bodies on banking regulation.

Task	Organization/Body
Scope of regulation	IMF, FSB
• Hedge funds	FSB, IOSCO
• "Too big to fail"	FSB
International cooperation	FSB
• Cross-border crisis management	FSB, BCBS, IAIS
Surveillance	IMF, assisted by FSB
Policy advice	IMF
Early warning	IMF, FSB
Regulatory regimes	IMF, FSB, BCBS, BIS
• Pro-cyclicality	FSB, BCBS, CGFS
• Capital adequacy	BCBS, IAIS
• Loan-loss provisioning	IASB
• Compensation schemes	FSB, BCBS, IAIS
• Credit-rating agencies	IOSCO
• CDSs, OTC derivatives	CPSS, IOSCO
Risk management	FSB, BCBS
• Stress-testing models	BCBS
• Structured products and securitization	BCBS, IOSCO
Market integrity	
• Securities rating	IOSCO
• Market manipulation and fraud	IOSCO
• AML/CFT	FATF
Accounting standards	IASB, BCBS
Audit	IFAC
Supervision	FSB, BCBS

IOSCO: International Organization of Securities Commissions

CGFS: Committee on the Global Financial System

IAIS: International Association of Insurance Supervisors

CPSS: Committee on Payment and Settlement Systems

IASB: International Accounting Standards Board

IFAC: International Federation of Accountants

AML/CFT: Anti-money laundering – combating the financing of terrorism

FATF: Financial Action Task Force on Money Laundering

Sources: G-20 documents, 2008–2010.

The main task of the subsequent meetings has been monitoring the implementation of the programme.

The G-20 was, as declared from the onset of its activities, deeply committed to the principles of free enterprise within free global flows of goods, services and capital, which were regarded as essential for economic growth and reduction of poverty. Nor did the G-20

design of 2008–2009 revise this basic view. "We recognize," the November 2008 Summit declared, "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." At the same time, the G-20 warned against "over-regulation that would hamper economic growth and exacerbate the contraction of capital flows, including to developing countries".[203]

The Chancellor of Germany, Angela Merkel, characterized the G-20 goal as "an international dimension of the social market economy", thus paralleling it with the post-World War II (West) German economic philosophy.[204] According to a senior official in the US Administration, the G-20 design was quite contrary to some preceding discussion of "an assault on capitalism", "the death of capitalism" and "the revamping of the free market system".[205] As President Bush put it: "(…) the question is, how do we establish good regulatory structure without destroying the incentive to innovate, without destroying the marketplace."[206] The London Summit, April 2009, spoke about "an open world economy based on market principles, effective regulation, and strong global institutions".[207]

The G-20 programme took the basic principles of the Basel Accord as given. The underlying view in the G-20 reports is that the grievance was not in the actual principles but rather in the failure to implement them. The G-20 programme strove, thus, to complement the Basel II Framework, to remedy the inadequacies which the crisis had revealed. The main elements of what can be discerned as the long-term G-20 stabilization programme are as follows: tightened

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203 "Declaration. Summit on Financial Markets and the World Economy, November 15, 2008" [12].

204 "Pressestatement von Bundeskanzlerin Angela Merkel und Bundesminister Peer Steinbrück", Washington DC, November 15, 2008, http://www.g8.utoronto.ca/g20/ (June 27, 2010).

205 "Press Briefing by Senior Administration Officials on Summit on Financial Markets and the World Economy", Washington DC, November 15, 2008, http://www.g8.utoronto.ca/g20/ (June 27, 2010).

206 "President Bush Attends Summit on Financial Markets and the World Economy. Remarks made by President George Bush at closing press conference", Washington DC, November 15, 2008, http://www.g8.utoronto.ca/g20/ (June 27, 2010).

207 "[Leaders Statement:] The Global Plan for Recovery and Reform, 2 April 2009" [3].

capital-adequacy requirements, control of compensation schemes, transparent accounting and disclosure standards, and tightened audit practices, complemented by a bank-restructuring fund to be raised from bank levies.

Banking regulation

Scope of regulation. The G-20 programme enlarged at least in principle the scope of banking regulations relative to the incumbent Basel II Framework. While the Basel Framework applies to "internationally active banks" (see p. 35), the G-20 sought regulation of "all systemically important institutions". Regulatory arbitrage, i.e. circumvention of regulations, was to be prevented. The regulatory systems were to be "compatible with a modern and increasingly globalized financial system". The November 2008 Summit, among other things, repeated the requirement that the G-20 members submit a Financial Sector Assessment Program (FSAP) report and demanded that it was to prepare a "review of the scope of financial regulation, with a special emphasis on institutions, instruments, and markets that are currently unregulated" to ensure that "all systemically-important institutions are appropriately regulated". It was separately pointed out that systemically important hedge funds were to be included in banking regulation and that regulatory oversight and registration were to be extended to credit-rating agencies. More effective regulation and oversight was demanded also for credit derivatives, as credit default swaps (CDS), and over-the-counter (OTC) derivatives transactions.[208]

International cooperation. Reinforcing international cooperation was a key element in the G-20 design. The G-20 stated that financial regulation belongs to the terms of reference of national authorities but pointed out that within a global financial market it was necessary to develop international cooperation and common international standards. In this respect, regulation and supervision of cross-border

[208] "Declaration. Summit on Financial Markets and the World Economy, November 15, 2008" [9–10, Action Plan (…)]; "[Leaders Statement:] The Global Plan for Recovery and Reform, 2 April 2009" [15]; "Declaration on Strengthening the Financial System – London, 2 April 2009".

banking required special attention. The November 2008 Summit regarded it necessary to establish supervisory colleges for all major cross-border financial institutions.[209] The FSF prepared a report for the April 2009 Summit, including a plan for supervisory colleges.[210]

Capital adequacy related to pro-cyclicality. From the November 2008 meetings onwards the G-20 paid attention to the built-in pro-cyclicality of the existing standards, included in the incumbent Basel Framework. The finance ministers and central bank governors "agreed that it is important to address the issue of pro-cyclicality in financial market regulations and supervisory systems". As one of the immediate actions, the Summit meeting urged the IMF, the FSF and other regulators and standard-setting bodies to "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". The definitions of capital were to be harmonized to achieve consistent measures of capital and capital adequacy.[211]

The FSF report to the April 2009 Summit distinguished three critical fields of banking regulation prone to pro-cyclicality: the capital regime, loan-loss provisioning, and the interaction between valuation and leverage. The FSF remarked, however, that new, tighter regulations could be implemented only after the economic crisis was over, so as not to harm the actual stimulus efforts.[212]

The FSF recommendations implied tightening of capital requirements with regard to the 8 per cent rule of the incumbent Basel Framework. The main recommendation for capital adequacy was countercyclical capital buffers. During strong economic conditions banks should build up high-quality capital buffers above the regulatory minimum, available to absorb greater losses in times of

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[209] "Declaration. Summit on Financial Markets and the World Economy, November 15, 2008" [8-9, Action Plan (…)].

[210] FSF, *FSF Principles for Cross-border Cooperation on Crisis Management*, 2 April 2009; "Declaration on Strengthening the Financial System - London, 2 April 2009".

[211] "G-20 Communiqué. Meeting of Ministers and Governors, São Paulo - Brazil, 8-9 November 2008" [6]; "Declaration. Summit on Financial Markets and the World Economy, November 15, 2008" [10, Action Plan (…)].

[212] FSF, *Report of the Financial Stability Forum on Addressing Procyclicality in the Financial System*, 2 April 2009, p. 1.

stress. The FSF also demanded a "clear definition" of what constitutes high-quality capital. Another demand for capital adequacy was developing stress-testing practices to validate the adequacy of banks' capital buffers. The FSF also suggested the introduction of a measure for total capital ratio to supplement the risk-based regulatory-capital requirements of incumbent stipulations, worded as "a simple, non-risk based measure to help contain the build-up of leverage in the banking system and put a floor under the Basel II framework".[213]

The FSF noticed that loan losses had been recognized at too late a stage of the credit cycle, hence their provisioning had remained over-optimistically insufficient. It also noticed inadequacies in the Basel Framework, which allowed including certain tranches of loan-loss provisions in regulatory capital. The FSF did not, however, present clear recommendations for loan-loss provisioning but tasked the BCBS, the FASB and the IASB to seek "alternative approaches" to develop methods for "through-the-cycle provisioning".[214]

The FSF noticed that extensive application of the so-called fair value or mark-to-market principle in the valuation of banks' capital had led to excessive credit expansion and thus excessive risk-taking. The problem was aggravated by maturity mismatches, i.e. funding of long-term assets by short-term liabilities. The FSF urged the standard-setting bodies to study further methods to measure and regulate the interaction between valuation and leverage.[215]

The G-20 meetings, March-April 2009, agreed with the FSF view. Building up capital buffers above the required minima was the most topical recommendation. The Summit supported the idea of supplementing the risk-based capital requirements with a measure for total capital ratio. Like the FSF, the G-20 pointed out that new capital requirements could not be implemented immediately, during the actual crisis, but as soon as recovery would be assured regulatory standards should also be strengthened. The London Summit urged the BCBS to review the minimum levels of capital and develop

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[213] FSF, *Report of the Financial Stability Forum on Addressing Procyclicality in the Financial System*, 2 April 2009, p. 2-3, 14-18.

[214] FSF, *Report of the Financial Stability Forum on Addressing Procyclicality in the Financial System*, 2 April 2009, p. 4-5, 19-22.

[215] FSF, *Report of the Financial Stability Forum on Addressing Procyclicality in the Financial System*, 2 April 2009, p. 5-7, 23-27.

recommendations in 2010.[216] The Pittsburgh Summit required that banks retain a sufficiently large proportion of profits to build up capital to support lending, and that "internationally agreed rules to improve both the quantity and quality of bank capital and to discourage excessive leverage" will be developed by the end of 2010 and set the end of 2012 as the deadline for implementation.[217]

Compensation schemes. The G-20 meetings reacted fiercely to the compensation practices within the banking sector. It was considered that "perverse" incentives had essentially contributed to excessive risk-taking and thus to the crisis. The November 2008 meetings demanded emphatically, as one of the most urgent tasks, that "action needs to be taken, through voluntary effort or *regulatory action* [italics – TP], to avoid compensation schemes which reward excessive short-term returns or risk taking".[218]

The FSF criticized the past goings-on in compensation practices:

> "High short-term profits led to generous bonus payments to employees without adequate regard to the longer-term risks they imposed on their firms. These perverse incentives amplified the excessive risk-taking that severely threatened the global financial system and left firms with fewer resources to absorb losses as risks materialised. The lack of attention to risk also contributed to the large, in some cases extreme absolute level of compensation in the industry."

The FSF concluded: "This must change."[219]

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[216] "G-20 Communiqué. Meeting of Finance Ministers and Central Bank Governors, United Kingdom, 14 March 2009" [6]; "[Leaders Statement:] The Global Plan for Recovery and Reform, 2 April 2009" [15]; "Declaration on Strengthening the Financial System – London, 2 April 2009" (The stance for a total capital ratio is worded: "risk-based capital requirements should be supplemented with a simple, transparent, non-risk based measure which is internationally comparable, properly takes into account off-balance sheet exposures, and can help contain the build-up of leverage in the banking system").

[217] "Leaders' Statement: The Pittsburgh Summit. September 24–25, 2009" [12–13].

[218] "G-20 Communiqué. Meeting of Ministers and Governors, São Paulo – Brazil, 8–9 November 2008" [6]; "Declaration. Summit on Financial Markets and the World Economy, November 15, 2008" [9, Action Plan (...)].

[219] FSF, *FSF Principles for Sound Compensation Practices*, 2 April 2009, p. 1.

According to the FSF, "experts" regarded the compensation practices not as the "sole cause" of the crisis but, nevertheless, as a significant factor behind the development. Without regulation of compensation practices, the FSF concluded, the other regulations would lose a considerable part of their effect. The FSF considered it necessary to regulate compensation practices all along the line, not only for those institutions which received governmental capital support as the practice was at that time.

The FSF found it difficult to design detailed instructions applicable to individual cases. The two main principles for sound compensation practices were that "[p]ayments should not be finalized over short periods where risks are realized over long periods", i.e. compensation was to be based on long-term performance, and the compensation was to be related to the risks involved. The FSF also paid attention to the fact that good performance had increased compensation considerably, while poor performance had diminished it relatively less.[220] The new FSB prepared more detailed guidelines for the Pittsburgh Summit, September 2009. The FSB Principles included, for example, that for senior executives a substantial portion of the compensation was to be variable, i.e. performance-related, to be paid under deferral arrangements and in the form of shares or related instruments. Further, among other things, supervisors had to be empowered to interfere in a firm's compensation practices if they deviated from the standards and that an already paid award not based on performance should be clawed back.[221]

The April 2009 Summit supported the idea of the new, tougher principles for sustainable compensation schemes, suggested by the FSF.[222] In line with the FSF, the Summit was decisively opposed to compensation based on short-term profits. "Payments should not be finalised over short periods where risks are realised over long periods (...)". The Summit instructed: "Supervisors will assess firms' compensation policies as part of their overall assessment of their soundness."[223] The Pittsburgh Summit, September 2009, approved the

[220] FSF, *FSF Principles for Sound Compensation Practices*, 2 April 2009, p. 2–14, 3 (quat.).

[221] FSB, *FSB Principles for Sound Compensation Practices. Implementation Standards*, 25 September 2009.

[222] "[Leaders Statement:] The Global Plan for Recovery and Reform, 2 April 2009" [15].

[223] "Declaration on Strengthening the Financial System – London, 2 April 2009".

detailed FSB Principles. As a corrective measure for non-compliance with the Principles was mentioned higher capital requirements.[224]

Risk management. Among immediate actions, the November 2008 Summit urged regulators to develop guidance for and to encourage financial institutions to adopt improved practices for risk management. Supervisors had to ensure that financial institutions develop processes for measurement of risk concentrations. Financial institutions were urged to exercise effective risk management and due diligence especially over structured products and securitization, as well as to reassess their stress-testing methods and report to supervisors accordingly. International standard setters had to set out strengthened capital requirements for banks' securitization activities, especially on structured products. The Summit urged the BCBS to develop new stress-testing models. One simple recommendation was creating strong liquidity cushions. [225]

The November 2008 Summit paid attention to the professional competence of national regulatory authorities. International standard-setting bodies were urged to "ensure that regulatory policy makers are aware and able to respond rapidly to evolution and innovation in financial markets and products". National authorities should also monitor substantial changes in asset prices and assess their implications for the economy and the financial system.[226]

Accounting standards. For accounting standards, the G-20 goal was "a single high-quality global standard", which would increase transparency and accountability in the financial market, covering also off-balance sheet operations. Accurate disclosure was demanded of firms both of their financial condition in general and particularly for complex securities. The G-20 expected that private sector bodies that had already developed best practices should make proposals to

[224] "Leaders' Statement: The Pittsburgh Summit. September 24–25, 2009" [12–13].

[225] "Declaration. Summit on Financial Markets and the World Economy, November 15, 2008" [9, Action Plan (...)].

[226] "Declaration. Summit on Financial Markets and the World Economy, November 15, 2008" [Action Plan (...)].

national authorities and the FSF/FSB.[227] The November 2008 Summit described the targeted disclosure system:[228]

> "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's 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."

The Pittsburgh Summit, September 2009, urged the international standard-setting bodies to complete their work for "a single set of high quality, global accounting standards" by June 2011.[229]

Market integrity. The G-20 decisions emphasized transparency as the indispensable precondition for market integrity, i.e. reliability of actors and assets in the financial market. The G-20 view implies, for example, arrangements which in recent discussion have been called investor protection, meaning analogous arrangements with regard to financial products to what in advanced countries is already known as consumer protection with regard to consumer goods. In other words, securities should be as transparent as possible to enable people to invest their savings as safely as possible.[230]. The November 2008 Summit demanded "business conduct rules to protect markets and investors, especially against market manipulation and fraud".[231] The G-20 programme emphasized the need to control credit and securities rating agencies, which had to meet the highest IOSCO standards. The rating agencies had to avoid interest conflicts, i.e. those persons

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227 "Declaration. Summit on Financial Markets and the World Economy, November 15, 2008" [9–10, Action Plan (...)]; "[Leaders Statement:] The Global Plan for Recovery and Reform, 2 April 2009" [15]; "Declaration on Strengthening the Financial System – London, 2 April 2009".

228 "Declaration. Summit on Financial Markets and the World Economy, November 15, 2008" [Action Plan (...)].

229 "Leaders' Statement: The Pittsburgh Summit. September 24–25, 2009" [14].

230 Cf. e.g. Shiller (2008), pp. 129–130.

231 "Declaration. Summit on Financial Markets and the World Economy, November 15, 2008" [Action Plan (...)].

in charge must not be personally involved in the firms or securities concerned, and thus able to provide unbiased information and assessments.[232]

Moral hazard connected to "too big to fail". An underlying basic idea of the long-term G-20 programme is to limit the possibility of moral hazard within a financial system which consists of large, systemically important financial institutions. There is, however, seemingly no final solution to the problem of "too big to fail". Modern financial institutions are irrevocably large, international corporations. Bank restructurings during the crisis tended to make the banks even bigger. In the first place, according to the G-20 view, the new global financial architecture should prevent financial crises from emerging.

In the case of failures, the main G-20 principle is that the financial institution concerned will pay as large a part as possible of the resolution costs to minimize the costs to taxpayers. The finance ministers' and central bank governors' meeting, March 2009, mentioned the contribution by shareholders to rescue operations and the right incentives as suitable means to prevent or limit moral hazard.[233] The Pittsburgh and Toronto summits, September 2009 and June 2010, respectively, spoke about the need for institution-specific resolution plans for large financial institutions. A fund to be gathered from levies on financial operations seems to be the primary solution for financing future bank resolutions, even though the Toronto Summit referred to this solution only vaguely – obviously because of the Canadian objection. (Canada has opposed a global bank levy on the basis that its banking system did not have any insolvency problems.[234]) The summits gave the FSB the task to prepare a more detailed proposal by the Seoul Summit, November 2010.[235]

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[232] "Declaration. Summit on Financial Markets and the World Economy, November 15, 2008" [Action Plan (...)]; "Declaration on Strengthening the Financial System – London, 2 April 2009".

[233] "G-20 Communiqué Annex. Meeting of Finance Ministers and Central Bank Governors, United Kingdom, 14 March 2009. Restoring lending: a framework for financial repair and recovery" [4, 7].

[234] "Canada opposes bank levy in letter to G20", April 14, 2010; "UPDATE 3-Canada opposes bank levy in letter to G20", April 14, 2010, http://www.reuters.com/ (September 3, 2010).

[235] "Leaders' Statement: The Pittsburgh Summit. September 24–25, 2009" [13]; "The G-20 Toronto Summit Declaration, June 26–27, 2010", "Annex II. Financial Sector Reform" [16–23].

Criminal and illicit activities

Crisis management gave the G-20 new impetus to and created a responsive political atmosphere for combating criminal and illicit activities, questions which had been on the G-20 agenda from the onset. One task of international supervisory cooperation was to protect the international financial system from illicit actors. In 2008–2009, combating uncooperative and non-transparent jurisdictions that pose risks of illicit financial activity became even more topical. The Washington and London summits, November 2008 and April 2009, respectively, reaffirmed the G-20 commitment to what has been called "anti-money laundering – combating the financing of terrorism" (AML/CFT) and reaffirmed its support for the Financial Action Task Force on Money Laundering (FATF); the summits also affirmed their support for the Stolen Asset Recovery (StAR) Initiative against corruption, initiated by the World Bank and the IMF. The summits pledged to continue, in cooperation with the OECD and other organizations, efforts to promote exchange of tax information to prevent tax evasion.[236] The Pittsburgh Summit, September 2009, urged the FATF to issue a public list of high risk jurisdictions by February 2010 and resorted especially to StAR to prevent illicit capital outflows from developing countries.[237]

The London Summit, April 2009, declared its readiness to deploy sanctions against tax havens. "The era of banking secrecy is over." The Summit referred to the United Nations Model Tax Convention instead of the OECD but otherwise the G-20 efforts still leant on the OECD Global Forum on Taxation as before. The Summit could note that, on the same day the declaration was issued, the OECD published a country list on observance of the international standard for exchange of tax information.[238] The September 2009 meetings declared their preparedness to use countermeasures against tax

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[236] "Declaration. Summit on Financial Markets and the World Economy, November 15, 2008" [Action Plan (...)]; "Declaration on Strengthening the Financial System – London, 2 April 2009".

[237] "Leaders' Statement: The Pittsburgh Summit. September 24–25, 2009" [15, 42].

[238] "[Leaders Statement:] The Global Plan for Recovery and Reform, 2 April 2009" [15]; "Declaration on Strengthening the Financial System – London, 2 April 2009".

havens from March 2010.[239] According to the OECD progress report, April 2010, all the 86 jurisdictions surveyed by the Global Forum had committed themselves to the internationally agreed tax standard, and 69 of them also had "substantially implemented" their commitment, in contrast with the 40 "substantially implemented" and four "not committed" out of 82 countries the previous year.[240]

Emerging and developing economies

As stated above, the crisis gave even more emphatic impetus to supporting the cause of the developing countries. The 2008–2009 meetings, for example, again reaffirmed the G-20 commitment to the UN Millenium Development Goals.[241] From the Pittsburgh Summit on, the United Nations Conference on Trade and Development (UNCTAD) was included in the organizations through which the G-20 was to implement its goals, but its role in the G-20 policies remained marginal.[242]

With the financial crisis, the G-20 meetings paid increased attention to the discrepancy that the institutions of the global economy were continuously governed by the traditional industrial states of the West, while, at the same time, the relative economic weight was moving to the emerging and developing economies

[239] "G-20 Communiqué. Meeting of Finance Ministers and Central Bank Governors, London, 4–5 September 2009. Declaration on Further Steps to Strengthen the Financial System" [4]; "Leaders' Statement: The Pittsburgh Summit, September 24–25, 2009" [15].

[240] "A progress report on the jurisdictions surveyed by the OECD Global Forum in implementing the internationally agreed tax standard. Progress made as at 21st April 2010", http://www.oecd.org/dataoecd/50/0/43606256.pdf; "A progress report on the jurisdictions surveyed by the OECD Global Forum in implementing the internationally agreed tax standard. Progress made as at 2nd April 2009", http://www.oecd.org/dataoecd/38/14/42497950.pdf.

[241] "G-20 Communiqué. Meeting of Ministers and Governors, São Paulo – Brazil, 8–9 November 2008" [14]; "[Leaders Statement:] The Global Plan for Recovery and Reform, 2 April 2009" [25]; "Leaders' Statement: The Pittsburgh Summit. September 24–25, 2009" [37].

[242] "Leaders' Statement: The Pittsburgh Summit. September 24–25, 2009" [48]; "G-20 Communiqué. Meeting of Finance Ministers and Central Bank Governors, United Kingdom, 7 November, 2009" [3]; "G-20 Communiqué. Meeting of Finance Ministers and Central Bank Governors, 23 April 2010".

of Asia and also Latin America. It may be difficult for the leading Western countries to relinquish their leading position and for the United States to give up its stipulated-minority position when, in the future, its relative weight eventually sinks below the critical level.[243] On the other hand, the emerging economies seem not to have been very anxious to receive the new economic responsibility offered to them. Obviously the most crucial question is not of power positions. The core problem is that the main responsibility for the central institutions of the world economy lies with countries whose resources are relatively waning. This necessitates a shift in "power relations" within global economic governance.

The G-20 meetings of November 2008 warmly supported the reform of the Bretton Woods organizations, "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 were to "have greater voice and representation" within them.[244] The April 2009 Summit committed itself to implement the IMF quota and voice reform, agreed upon in April 2008, and urged the IMF to complete the next review of quotas by January 2011. The Summit also committed itself to implement the World Bank reforms agreed upon in October 2008.[245] The Pittsburgh Summit, September 2009, specified the targeted scale of the IMF quota reform as an at least 5 per cent shift from over-represented countries to under-represented emerging markets and developing countries, using the recently approved new quota formula (see p. 28) as the indicative basis. The targeted scale of the World Bank governance reform was specified as an at least 3 per cent increase in voting power for under-represented developing and transition countries. According to the Summit, the IMF should remain a quota-based organization, while the distribution of quotas should reflect the relative weights of its members in the world economy, i.e. the underrepresented countries

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[243] Väyrynen (2009), pp. 17–18.

[244] "G-20 Communiqué. Meeting of Ministers and Governors, São Paulo – Brazil, 8–9 November 2008" [12–13]; "Declaration. Summit on Financial Markets and the World Economy, November 15, 2008" [9, Action Plan (...)].

[245] "[Leaders Statement:] The Global Plan for Recovery and Reform, 2 April 2009" [20].

are presumed to subscribe to increased quotas.[246] Appointing the leadership should take place "through an open, transparent, and merit-based process".[247] The International Monetary and Financial Committee (IMFC) of the IMF affirmed this goal.[248]

The November 2008 meetings of the G-20 decided to enlarge the membership of the FSF, the main international standard-setting body for financial regulation, to comprise the most important emerging economies.[249] The FSF was already in Spring 2009 expanded to comprise all those G-20 countries that were not yet members, i.e. Argentina, Brazil, China, India, Indonesia, Korea, Mexico, Russia, Saudi Arabia, South Africa and Turkey; in addition, Spain, and the European Commission joined. The FSF was renamed the Financial Stability Board (FSB).[250] The BCBS was expanded in 2009 by inviting Australia, Brazil, China, Korea, India, Mexico and Russia in March, and Argentina, Indonesia, Saudi Arabia, South Africa and Turkey in June, which meant the BCBS comprised, among others, all the G-20 countries.[251]

Solemn declarations?

The G-20 declarations include a number of solemn promises without intensive efforts to implement them. Expressions of solidarity with

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[246] "Leaders' Statement: The Pittsburgh Summit. September 24–25, 2009" [Preamble: 20–21; 21, 27].

[247] "[Leaders Statement:] The Global Plan for Recovery and Reform, 2 April 2009" [20]; "Leaders' Statement: The Pittsburgh Summit. September 24–25, 2009" [21].

[248] "Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund", Press Release No. 09/347, October 4, 2009, http://www.imf.org/external/np/sec/pr/2009/pr09347.htm

[249] "G-20 Communiqué. Meeting of Ministers and Governors, São Paulo – Brazil, 8–9 November 2008" [15]; "Declaration. Summit on Financial Markets and the World Economy, November 15, 2008" [9, Action Plan (...)].

[250] FSF, Press Release 9/2009, 12 March, 2009; Financial Stability Forum, Press Release 14/2009, 2 April, 2009, http://www.financialstabilityboard.org/ (April 4, 2010).

[251] "Expansion of membership announced by the Basel Committee", 13 March 2009; "Basel Committee broadens its membership", 10 June 2009, http://www.bis.org/ (August 27, 2010).

the world's poor can be understood to refer to the economic-development perspectives of the developing countries within the global market economy and to the G-20 efforts to foster stimulus in the poorest and most badly hit countries. The April 2009 Summit, for example, aimed at "a fair and sustainable recovery for all". The leaders declared their intentions to "recognise the human dimension to the crisis" and to "commit to support those affected by the crisis". They promised to "build a fair and family-friendly labour market for both women and men", and declared their solidarity with the International Labour Organization (ILO).[252] The Pittsburgh Summit, September 2009, appealed to the fundamental principles of the ILO.[253]

On the question of climate change, the G-20 declared their endeavour to reach an agreement at the United Nations Climate Change Conference in Copenhagen in December 2009.[254] As worded by the Pittsburgh Summit, September 2009, the G-20 leaders would "spare no effort to reach agreement in Copenhagen".[255] As is generally known, the decisions of the conference were watered down to an empty declaration of endeavour, carried out under the leadership of the United States and supported by the main emerging economies, represented at the G-20.

All the G-20 meetings declared their desire to bring the Doha negotiations round of the WTO to a successful conclusion. According to the Pittsburgh Summit communiqué, September 2009, the G-20 leaders were "committed to bringing the Doha Round to a successful conclusion in 2010" while the Toronto Summit, June 2010, "reiterated" its support to bring the round "to a balanced and ambitious conclusion as soon as possible".[256] The near future will prove the seriousness of the political leaders' promises and "commitments".

Pieces of verifiably empty rhetoric foreshadow the fear that many or at least some of the pledges, declared unanimously by the G-20 meetings, could be equally empty rhetoric, intended to satisfy

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[252] "[Leaders Statement:] The Global Plan for Recovery and Reform, 2 April 2009" [25–28].

[253] "Leaders' Statement: The Pittsburgh Summit. September 24–25, 2009" [43, also 44–47].

[254] "[Leaders Statement:] The Global Plan for Recovery and Reform, 2 April 2009" [28].

[255] "Leaders' Statement: The Pittsburgh Summit. September 24–25, 2009" [Preamble: 29; cf. 32].

[256] "Leaders' Statement: The Pittsburgh Summit, September 24–25, 2009" [Preamble: 28; 15]; "The G-20 Toronto Summit Declaration, June 26–27, 2010" [38].

the advocates of reform as long as the discussion is going on, but to be forgotten as soon as the distress is over. The US Secretary of the Treasury Tim Geithner addressed the question at the Pittsburgh Summit, September 2009, as follows: "(...) we need to act before the memory of the crisis fades and before the impetus for reform recedes." [257] The next couple of years will verify the question.

[257] "Press Briefing by U.S. Treasury Secretary Tim Geithner on the G20 Meetings", September 24, 2009, Pittsburgh, http://www.g7.utoronto.ca/g20/.

7. Creating the 21st Century Global Economic Order

The recession of 2008–2009 has been characterized as the most severe financial crisis and economic setback in the world economy since the Great Depression of the early 1930s. The crisis was preceded by the emergence of the global market economy with a global financial system during the past two to three decades. Within the global market economy, by and large, goods, services and capital move almost freely among most countries of the world. Large-scale foreign direct investments fostered economic growth in low-wage countries which has resulted in the fact that since the end of the Cold War a number of emerging economies have arisen as significant entities in the world economy. Global imbalances, which accumulated substantially during the first years of the 2000s, aggravated the crisis of 2008–2009. Among these global imbalances, the twin deficit, i.e. the simultaneous deficit in public finance and the balance-of-payments deficit of the United States, has been the most fatal from the global stability point of view.

The crisis unfolded in the housing market of the United States, which was dominated by speculative fever from the early 2000s until about 2007. The ultimate cause of the crisis was excessive risk taking in the banking sector, the motive behind which was the pursuit of short-term profits on which bank executives' bonuses were based. Extensive credit expansion created a real-estate price bubble. Irresponsible banking was made possible by deficiencies in banking regulation and supervision. Virtually all the countries which are systemically important for the world economy, among them the United States, have adopted the international Basel Accord standards for banking regulation and supervision, designed to prevent large-scale financial crises. During the past decades, however, an increasing belief in the self-correction capabilities of the free market meant that largely, even among regulatory authorities, banking regulations were regarded as somewhat obsolete in a modern market economy. Credit defaults began to accumulate in 2007, leading to the implosion of the housing bubble in 2007–2008. General panic in the financial market was triggered by the failure of the US investment bank Lehman Brothers on September 15, 2008.

Illustrative of the American lending practices prior to the crisis were the subprime loans, which even became a symbol of the speculative housing boom. Subprime loans were granted to borrowers who could not actually afford their mortgage. The housing boom was heightened through large-scale securitization of mortgages. The resulting slump was aggravated by complex and opaque mortgage derivatives. Structured products called collateralized debt obligations, based, e.g. on subprime mortgages, as well as credit default swaps, originally intended as insurance against credit default but in fact often more like betting papers, became other symbols of the adventurous US banking.

The US financial crisis was immediately propagated abroad. In Western Europe, many banks were involved in American mortgage-related securities. Some West European countries had a housing boom of their own, albeit not as vigorous as in the US. Propagation of the crisis proceeded, however, mainly through a general contagion effect and repercussions in the real economy. A steep fall in production, investment etc. proceeded from Autumn 2008 until Spring 2009. To be sure, the fall in world GDP was only 0.6 per cent in 2009 on the basis of purchasing power parities, but it was distributed unevenly both in world-wide comparison and within regional groups of countries. (If converted through market exchange rates, the global fall was steeper, 2 per cent.) The general pattern was that the transitional economies of Eastern Europe were worst hit, followed by Western Europe, while the emerging and developing economies suffered less. Especially the emerging economies in Asia were hardly hit at all, as it soon became clear. In terms of GDP, the United States, the originator of the problems, was hit more mildly than the advanced economies in general.

As a result of prompt stimulus policies, the crisis was prevented from turning into a deep depression. It was confined to a relatively short-time recession lasting about a year, from Autumn 2008 to Autumn 2009.

Discrepancy between global problems and national and intergovernmental governance is characteristic of the world economy. Intergovernmental organizations such as the International Monetary Fund (IMF), the World Bank, the World Trade Organization (WTO)

and the Bank for International Settlements (BIS) organize cooperation between governments and central banks. International standard-setting bodies such as the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Forum (FSF), from Spring 2009 the Financial Stability Board (FSB), as the most central, prepare recommendations for harmonized standards in the financial market. The Organization for Economic Co-operation and Development (OECD) has played an important role in the international economy, but it does not include the large emerging economies. Political will is brought to international decision-making mainly by groups of leading states. Prior to the recent economic recession, the Group of Eight (G-8) was the leading consortium of powers deliberating global economic problems.

The Group of Twenty (G-20) was established in 1999. It consists of the 20 largest economies, including emerging economies, and comprises the bulk of the world economy. The crisis of 2008–2009 put the G-20 in charge of global economic governance. In Autumn 2008 the G-20 came out from the shadow of the G-8 and established itself as a kind of "world government". The G-20, not equipped with any decision-making powers, "governs" through international organizations and standard-setting bodies which implement its decisions. Obviously, the distress has created an atmosphere of togetherness in which governments are more prone than in normal times to conform to an international authority, at least temporarily and for a limited assignment.

The crisis of 2008–2009 marked a turning-point for the world economy and global economic governance in two respects: Firstly, it created, under the auspices of the G-20, a new preparedness for crisis management, based on voluntary cooperation and coordination of policies among sovereign states to an unprecedented degree. The G-20 meetings, notably the summits, defined guidelines for both actual crisis management and long-term planning for crisis prevention in the future. Secondly, it manifested the growing weight of the emerging economies in relation to the traditional advanced countries of the West within the world economy. Once the present distress is overcome, the central position of the G-20 will most probably fade. The events of 2008–2009 have, however, strengthened the consciousness of global interdependence, which suggests that a

large part of the new role which the G-20 gained during the crisis will endure.

When assessing the crisis management of 2008–2009, the first thing to notice is that for the first time in history the governments of the world were capable of developing concerted action against imminent depression with the principle "the global crisis requires global solutions". Keynesianism was generally adopted as an economic-policy doctrine. Monetary and fiscal-policy means were urgently deployed to turn the development back to the growth path.

To provide liquidity for the banking system, the steering interest rates were reduced, eventually to a "zero interest rate", i.e. close to zero, by Spring 2009. When the standard monetary-policy means turned out to be insufficient, a number of non-standard lending facilities were developed. The possibilities of monetary policies are, however, confined to remedying or mitigating liquidity problems, while the even more fatal problem in many countries, notably in the United States but also in some West European countries, was the insolvency of banks. Thus, policy makers had to resort to fiscal policy means to restore banks' balance sheets.

Most countries deployed fiscal-policy means to combat imminent depression. In advanced economies, notably in West European welfare states, automatic stabilizers play an important role in leveling down the impact of business cycles. Automatic stabilizers, however, do not suffice to maintain aggregate demand and employment in deep crises. Thus, large-scale stimulus packages were approved in different countries. In the United States and other housing-boom countries, bank bailout through capital injections and guarantees for banks' liabilities was of crucial significance for the resumption of solvency within the banking sector.

Banks were rescued through government finance because they were "too big to fail". The whole financial system would have collapsed if they had been allowed to go truly bankrupt. The decision-makers knew that bank bailout involves the threat of moral hazard. Bank executives are not discouraged from but, on the contrary, they can even be encouraged to continue adventurous banking practices if a gamble can only yield profits while losses are "socialized". Unjust

fiscal transfers were, nonetheless, regarded as a lesser evil compared to the collapse of the banking system.

The advanced countries and the financially strong emerging economies could finance their fiscal measures from their own resources. On the other hand, concerted international action was indispensable to assist the poorest countries, as well as the countries worst hit by the crisis. The G-20 cooperated especially with the IMF. The 1.1 trillion US dollars which the G-20 managed to raise to augment the IMF resources for anti-crisis policies was unprecedented in world history.

The fatal reverse side of the apparently successful stimulus policies was a public-debt crisis in many advanced economies. The Keynesian idea is that during a depression the government maintains aggregate demand through borrowing but the debt is to be repaid during the subsequent boom. During the recent recession many advanced economies became excessively indebted since politicians had, for reasons of convenience, resorted to debt financing already during the economic boom. The indebtedness allowance was, thus, consumed in advance. The result is, among other things, a threat of sovereign risk, i.e. the financial market will cease to trust the creditworthiness of the governments. The Euro Area fell into this trap. Excessive indebtedness has also resulted in many countries being forced to suspend the stimulus "prematurely" relative to economic needs. The crisis management stretched the resources for stimulus policies and banking bailouts to the utmost. Consequently, the present advanced countries can hardly afford a new financial crisis for a long time to come.

The financial crisis revealed the vulnerabilities of the global financial system. The G-20 decisions in 2008-2009 actually constitute a long-term Stabilization Programme to tackle these vulnerabilities, named by the Pittsburgh Summit, September 2009, a "Framework for Strong, Sustainable and Balanced Growth". The new financial architecture for the 21st century is intended to prevent similar crises in the future. The G-20 meetings demanded, among other things, a practice of early warning against risks incubating within the international financial system, for which above all the IMF and the FSB would be responsible. The G-20 meetings tasked international organizations, especially the IMF, and standard-setting bodies,

especially the FSB and the BCBS, with a large number of planning assignments dealing with separate questions.

The G-20 construction emphasizes effective banking regulation within the global market economy. The G-20 dissociated itself from the uncritical faith in the self-correction capabilities of the free market, which had been characteristic of economic thought prior to the crisis, but, nevertheless, adhered strictly to the principles of the global market economy and the global financial system. The G-20 decisions also include recommendations, particularly, to restore external balance and balance in public finance where these are disrupted, but recommendations aimed at legal stipulations were confined to the sphere of banking regulation – apart from measures against illicit activities. The G-20 programme strives to establish new rules for banking, better able to maintain financial stability, while the domains of national economic policies proper would be left basically intact. International coordination and cooperation has to be an integral part of banking regulations since cross-border banking has become the normal pattern of the modern financial system. The long-term G-20 stabilization programme can be summed up, in a nutshell, as follows: tightened capital-adequacy requirements, control of compensation schemes, transparent accounting and disclosure standards and tightened audit, complemented by a bank-restructuring fund to be raised from bank levies.

The G-20 decisions enlarge the scope of banking regulations to some extent relative to the practice thus far. While the incumbent Basel II Framework applies to "internationally active banks", the G-20 programme seeks regulation of "all systemically important institutions". It was separately pointed out that systemically important hedge funds are to be regulated and that regulatory oversight and registration is to be extended to credit-rating agencies. More effective regulation and oversight was also demanded for credit derivatives, as credit default swaps (CDS), and over-the-counter (OTC) derivatives transactions.

Most topically, the requirements for capital adequacy were to be overhauled. It was found that the capital-adequacy stipulations of the incumbent Basel II Framework, i.e. at least 8 per cent relative to risk-weighted assets, were ultimately pro-cyclical. The remedy was to form capital buffers above the minimum required thus far. According to the G-20 and the FSB, the banks had to accumulate

high-quality capital buffers in good times in order to absorb losses in times of stress. A measure of total capital ratio was also required to supplement the risk-based regulatory-capital requirements. Related to capital adequacy was provisioning for credit losses, which also turned out to have been pro-cyclical. Methods were to be developed for "through-the-cycle provisions". It was, however, pointed out that implementation of new, tighter capital requirements could begin only after the present financial crisis was overcome, so as not to impede actual stimulus efforts.

Compensation schemes formed a new topic to be tackled by banking regulations. It was found that compensation schemes within the banking sector had included "perverse" incentives which had encouraged excessive risk taking. According to the G-20 and the FSB, henceforth, compensation was to be based not on short-term profits but on long-term performance.

For risk management, practices of early warning against large risk concentrations within financial institutions were to be created. Demands were made for, among other things, stricter regulation of securitization, especially with regard to structured products, and the conducting of stress tests. The G-20 meetings also paid attention to the professional competence of national regulatory authorities, capable of following the development of new financial products.

Concerning accounting standards, the G-20 programme emphasized transparency. The goal was "a single high-quality global standard", which would increase transparency and accountability in the financial market, also covering off-balance sheet operations. Accurate disclosure was demanded from firms both of their financial condition in general and particularly of complex securities.

The question of market integrity, i.e. the reliability of actors and assets in the financial market, is related to what in recent discussion has been called investor protection, meaning analogous arrangements with regard to financial products as is already known in advanced countries as consumer protection with regard to consumer goods. In other words, securities should be as transparent as possible to enable people to invest their savings as safely as possible. G-20 demanded, among other things, "business conduct rules to protect markets and investors, especially against market manipulation and fraud". The rating agencies were to be regulated to ensure that they are capable of providing unbiased information and assessments.

Preventing moral hazard connected with the problem of "too-big-to-fail" is seemingly one of the most difficult problems to solve, since in the modern banking system substantially all banks are systemically too important to be allowed to go truly bankrupt. The G-20 programme construction, in general, aims to prevent situations involving the possibility of moral hazard. For the contingency of bank insolvency, the G-20 is seeking a solution to bank resolution without involving taxpayers' money. For the time being (August 2010), the question is under preparation within the FSB. So far, a fund to be collected from bank levies has been considered as a possible arrangement for this purpose.

The G-20 decisions envisage implementation of the new regulatory framework by the end of 2012. International standard-setting bodies have worked and are working to concretize the G-20 decisions. Especially the Basel Committee on Banking Supervision is finalizing revisions to the Basel II Framework, unofficially called Basel III, during 2010. The United States, i.e. the Obama administration, seems to be a forerunner in this respect. Also the European Commission is preparing new provisions for banking regulation. The next couple of years will prove to what extent the pledges given in a moment of distress will be translated into practice. It is obvious that the same actors who created the recent crisis will not voluntarily give up their profit opportunities. Probably, the world economy will develop on a more stable path in any case. The crisis has raised a widely-based consciousness of the necessity of effective banking regulation on the basis of international standards, as well as of international coordination of economic policies within the national domains. The crisis has also been a lesson to investors about wariness with regard to financial products.

The crisis of 2008–2009 created a responsive political atmosphere to intensify the fight against illicit activities and to tackle the problem of uncooperative jurisdictions, which had been on the G-20 agenda from the very beginning. The new political atmosphere especially promoted efforts to deal with tax evasion. The September 2009 meetings of the G-20 already declared their preparedness for international sanctions against tax havens from March 2010 onwards. The Organization for Economic Co-operation and Development (OECD) has reported

considerable progress in countries' commitment to international standards for exchange of tax information.

The crisis of 2008–2009 involved a conspicuous march of the emerging economies on the world economy scene. During the past decades, essentially since the Cold War, more rapid economic growth in the emerging and developing economies has brought about a gradual shift in world economic weights. Especially the emerging economies in Asia, notably China but also India and the South-East Asian countries, have arisen as entities of world-wide significance. Latin America is also reckoned as a significant economic region. The uneven effect of the recent crisis on different parts of the world marked a sudden further shift in the same direction. The crisis hit mainly the advanced economies and even more Eastern Europe, but virtually not at all the emerging economies in Asia where undisrupted economic growth continued. When world trade fell, the emerging Asian countries managed, to a great extent, to substitute domestic demand for exports. Even among the developing countries the effect of the crisis was relatively modest. The post-crisis differences in growth rates will promote global convergence even further. The Asian financial crisis of 1997–1999 still took place in the "periphery". A new one in the future, if the G-20 Framework should fail, could already form an epicentre.

Transformation of global economic governance is a result of shifting economic weights. The crisis alerted the international community to the awareness that the resources of the Western countries to perform leadership functions are relatively waning. The clearest manifestation of this is the appearance of the G-20 as the main forum of global economic deliberations.

The clearest discussion on global governance has concerned the Bretton Woods organizations, i.e. the IMF and the World Bank. The governance reform was discussed and prepared throughout the 2000s, but the discussion was accentuated by the coming of the G-20 into focus. The G-20 meetings actively supported the demand to give the emerging and developing economies "greater voice and representation" to "more adequately reflect the changing economic weights in the world economy". The result was that the share of the emerging and developing economies within these organizations was enhanced, albeit moderately at this stage. The governance reform

was extended – less conspicuously – to the central international standard-setting bodies. The FSB and the BCBS were complemented by representatives of the emerging economies.

The transformation of global economic governance will obviously be a gradual process, as indicated by the cautiousness of IMF and World Bank reforms thus far. There are two crucial questions: Are the advanced countries ready to relinquish the leading position which they have occupied so far, and, how anxious are the emerging and developing economies really to adopt more responsibility for global governance? A leading position does not primarily involve advantages from the national interest point of view but rather liabilities in terms of the poorest countries.

For the United States, the relationship with China has become the primary concern. The post-World War II Transatlantic Relationship has been replaced by connections across the Pacific as the main axis for international economic exchange. Europe, which once created the global economic network, is being relatively marginalized on a world-wide scale.

There has been discussion about the future of the US dollar as the main reserve currency. Even though the relative weight of the United States in the world economy is fading, there seems to be no alternative to the dollar as the leading world currency, albeit its position may weaken. In spite of the recent debacles, the euro may reinforce its position as a regional reserve currency but can hardly challenge the dollar because of the marginalized position of Europe. The present emerging economies should, at least, liberalize their capital-account transactions to make their currencies capable of functioning as an international reserve currency. There have also been discussions about a world reserve currency, separate from national currencies, but this does not seem feasible in the foreseeable future.

The 21st century seems to be characterized by a basically multilateral international economic order, within which regional integration will play an important role even outside Western Europe. The developments during the recent crisis indicate that in the future the emerging and developing economies will be less dependent on export-led growth and supported more by domestic demand. However, most probably, the traditional advanced countries will continue to be in the leading position for a relatively long time since they are the core high-tech economies.

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Acronyms

ABS	Asset-backed security
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
CDO	Collateralized debt obligation
CDS	Credit default swap
CIS	Commonwealth of Independent States
EC	1) European Communities (until 1993); 2) European Community (from 1993)
ECB	European Central Bank
EMU	Economic and Monetary Union
EU	European Union
FASB	Financial Accounting Standards Board
FCL	Flexible Credit Line
FDI	Foreign direct investment
Fed	Federal Reserve System
FSB	Financial Stability Board
FSF	Financial Stability Forum
G-10	Group of Ten
G-5	Group of Five
G-7	Group of Seven
G-8	Group of Eight
G-20	Group of Twenty
GAB	General Arrangements to Borrow
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
IASB	International Accounting Standards Board
IBRD	International Bank for Reconstruction and Development (i.e. World Bank)
IFI	International Financial Institution
ILO	International Labour Organization
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IT	Information technology
MBS	Mortgage-backed security
MDB	Multilateral Development Bank
MFI	Multilateral Financial Institution
MRO	Main Refinancing Operations

NAB	New Arrangements to Borrow
OECD	Organization for Economic Co-operation and Development
PPP	Purchasing power parity
SDR	Special Drawing Rights
SGP	Stability and Growth Pact
SIV	Structured investment vehicle
StAR	Stolen Asset Recovery (Initiative)
TARP	Troubled Asset Relief Program
WTO	World Trade Organization

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Overhauling the Global Economic Governance as a Result of the Financial Crisis, 2008–2009

Tapani Paavonen

The Financial Crisis of 2008–2009 dealt a serious blow to the belief that an unregulated economic order could maintain stability in the world economy. In Autumn 2008, notably the Group of Twenty (G-20), consisting of the twenty largest economies, undertook to organize world-wide concerted action against depression.

Prompt stimulus managed to confine an imminent depression to a relatively short recession, but it led to excessive public debt in many countries. The lesson is that economic fluctuations are manageable, but governments must prepare manoeuvring room for stimulus by melting down public debt in years of economic boom.

The G-20 effort to prevent similar crises in the future generated a grandiose design to overhaul the regulation on financial institutions within the framework of the global market economy. For the time being, the new guidelines are being implemented in different countries.

The crisis also manifested the rise of the emerging economies to prominence within the world economy. This will be reflected, for example, as a more remarkable role in the global economic governance.

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