On the Street – G20: Build Confidence At Any Cost

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The pressure on G20 members was very high given the divergences of goals, while failure was not a possible option. A failure to forge a consensus might have set back the world's economy and markets just as they're showing signs of shaking off the worst financial crisis in decades. That's what happened in 1933, when US President Franklin D. Roosevelt torpedoed a similar conference in London by rejecting its plan to stabilise currency rates and in the process scotched international efforts to lift the world out of a depression.

However, at the end of a summit in London, policy makers from the Group of 20 yesterday delivered a regulatory blueprint that French President Sarkozy said turned the page on the Anglo-Saxon model of free markets by placing stricter limits on hedge funds and other financiers. The leaders also pledged to triple the resources of the International Monetary Fund and to hand China and other developing economies a greater say in the management of the world economy.

Action

In term of increasing the support to Multilateral Financing Institutions (MFIs), leaders agreed to the following support:

- $750 billion in funding for the IMF through both a new $250 billion Special Drawing Right allocation and $500 billion more for the New Arrangements to Borrow.
- $100 billion for the World Bank.
- $250 billion in trade finance through MFIs and national export credit.

Conciliation

In a conciliation effort, President Obama soft-pedalled earlier US demands that the summit agreed on a specific target for fiscal stimulus in the face of opposition from France and Germany. Instead, he settled for a vague pledge that the leaders would do whatever it takes to revive the global economy. The President also signed on to a communiqué that Nobel Laureate Joseph Stiglitz said repudiated the previous US-led push to free capitalism from the constraints of governments. "*This is a major step forward and a reversal of the ideology of the 1990s, and at a very official level, a rejection of the ideas pushed by the U.S. and others*," said Stiglitz. "*It's a historic moment when the world came together and said we were wrong to push deregulation*." In bowing to that view, the leaders conceded in a statement that "major failures" in regulation had been "fundamental causes" of the market turmoil they are trying to tackle. To make amends and to try to avoid a repeat of the crisis, they pledged to impose stronger restraints on hedge funds, credit rating companies, risk-taking and executive pay.

Harmonization

Citi economists Don Hanna and Jurgen Michels called the summit agreement "a boon to emerging markets", as a result of the recognition of the greater importance of Emerging Countries in the world economy. This recognition is reflected through the increase of the Special Drawing Rights as these allocations can be drawn down without conditionality.

Special Drawing Rights is the artificial currency that the IMF uses to settle accounts among its member nations. The move is similar to a central bank such as the Federal Reserve effectively creating money out of thin air, except it's on a global scale.

The increase in Special Drawing Rights will allow countries to tap IMF money without having to accept changes to economic policies often demanded as a condition of aid. The cash is disbursed in proportion to the money each member-nation pays into the fund. Rich nations will be allowed to divert their allocations to countries in greater need. Furthermore, the G20 said they would couple the financing moves with steps to give emerging economic powerhouses such as China, India and Brazil a greater say in how the IMF is run.

Finally, a new Financial Stability Board will be established to unite regulators and join the IMF in providing early warnings of potential threats. Once the economy recovers, work will begin on new rules aimed at avoiding excessive leverage and forcing banks to put more money aside during good times.

Missing Pieces

Although the summit outcomes were beyond markets expectations, our analysts observe that the G20 did not agree on additional fiscal measures, probably reflecting the resistance by continental European summit participants. Furthermore, in their view, the G20 leaders did not properly address the ongoing problem in the financial system. Instead of approving a "global bank rescue plan" the G20 leaders only agreed to say in the communiqué that they "are committed to take all necessary actions to restore the normal flow of credit through the financial system and ensure the soundness of systemically important institutions, implementing our policies in line with the agreed G20 framework for restoring lending and repairing the financial sector."

Note: The G20 members are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, South Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the USA, the UK and the EU.

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