

ICRIER's 12th Annual International G20 Conference titled "*Protecting Human Lives and Restoring Economic Stability: Views from the G20 Members*"_October 5-8, 2020

Evaluating Global Financial Architecture and Regulatory Practices – Progress and the Way Forward, October 5, 2020 (Monday) from 17.00 – 18:30 Hrs (IST)

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1. I have been asked to speak on my experiences in the G 20 in the thematic areas of the Global Financial Architecture and Financial regulatory Reform. I represented India in the first seven G 20 summits. My point of departure is therefore the Global Financial Crisis of 2008. This was the trigger for elevating what was a Finance Ministers forum to Summit level.
2. The Global Financial architecture on the eve of the global financial crisis of 2008 can be seen as a triptych with international capital markets dominated by AEs at the centre, bilateral and multilateral assistance on which developing countries were dependent for balancing their current accounts on one side frame, and the large self-insurance mechanism of FC reserves of major Emerging markets on the second side frame. The three frames themselves can be seen encased within the international monetary system, with the US dollar as the de facto global reserve currency.
3. EMDEs had long accessed international capital markets for commercial borrowings and private equity flows. These markets however exposed them to the vagaries of shifts in US Federal Reserve policies, sudden stops and BOP crises. This is what happened during the Latin American debt crisis of the 1980s, India's BOP crisis of the early 1990s and the Asian Financial crisis of the late nineties.
4. The resources of MDBs however did not grow in tandem with their external financing needs on the one hand. They built up their own self-insurance mechanism of FC reserves, aided by their strategy of export led hyper growth. This resulted in mounting global imbalances. These were recycled to finance a consumption boom in AEs, in particular the US, just as the recycling of oil surpluses had earlier financed a consumption boom in Latin America.
5. In the case of Latin America, India and Asia, the consumption boom ended with sudden stops and BOP crises. In the US, with the enormous privilege of the global reserve

currency, the end of the consumption boom arising out of a reversal in Fed monetary policy resulted in a major financial crisis emanating from the shadow banking system.

6. Weaknesses in the financial system were consequently seen very early on by the G 20 as one of the two ultimate causes of the GFC, the other being global imbalances.
7. The Leaders Statement in the first three G 20 summits at Washington DC, London and Pittsburgh spelt out in some detail the direction of the reforms needed. One of the first four WGs set up by the G 20, of which India was a co-chair, was on regulatory reform of the financial system.
8. Alongside this, the Financial Stability Forum, a G7 club, was restructured into the Financial Stability Board by including all developing G 20 countries. The FSB was tasked by the G 20 to monitor the formulation and implementation of financial sector reforms, and coordinate with various standard setting bodies such as BCBS and IOSCO, and report back to the G 20. There were updates by the FSB at all deputies meetings in the finance track, and an annual report to leaders.
9. The issue of Global imbalances was addressed through the Framework for Strong, Sustainable and Balance Growth, launched at the third G 20 summit at Pittsburgh. The Framework Working Group was to evolve into the flagship Working Group of the G 20, with India as one of the co-chairs, alongside Canada.
10. Since EMDE financial markets were already fairly tightly regulated, they were not very engaged in the intense G 20 debates over financial regulation. These were mainly between the US and UK on the one hand, who batted for lighter touch regulation, and Europe on the other that pitched for tighter regulation.
11. Emerging Market concerns, including India's, were centred on evolving a G 20 consensus on macroprudential regulation that would enable them to deal with volatile and destabilizing capital flows, exacerbated by largescale Quantitative Easing in AEs, that complicated their monetary management. While central banks were applauded for their swift action in stabilizing asset prices, unconventional monetary policies also came to be seen as a new source of froth in financial markets. QE also got drawn into the debate on global imbalances and currency wars, which was the biggest talking point at the fifth G

20 Summit at Seoul. The prevailing orthodoxy, underwritten by the IMF, was to move toward nonintervention in foreign currency markets and full convertibility. In this, the EMDEs were able to get their way by negotiating more policy space.

12. Their other concern was to build consensus on strengthening the Global Financial Architecture by bolstering global and regional safety nets, and to increase their own representation in its governance structure. Here too they were successful, as IMF's resources were increased, and their weight in its governance structure enhanced. They were however not the direct beneficiaries of the enhanced global safety net to which they contributed, as this was mostly used to bail out countries in the EMU. The G 20 EMs were largely self-insured, IMF procedures not considered nimble enough, and they were wary of entering into advance arrangements with the IMF on account of the stigma effect. Indeed, it was the US Federal Reserve that got off the block well before the IMF through swap arrangements with major central banks to provide standby dollar funding. One of the surprising outcomes of the GFC was the emergence of the US Federal Reserve, the issuer of the de facto global reserve currency, as a major pillar of the Global Financial Architecture. The French Presidency attempted to get the G 20 to address this enormous privilege of the US dollar in the international monetary system at the 6th Summit. That nothing came of this is a reflection of the sobering fact that this is a status bestowed by markets. There is little that governments and regulators can do about it.
13. The G 20 financial regulatory reform agenda as summarized by the FSB in G 20 meetings was based on four pillars: (a) strong regulatory framework – centred on implementing the new countercyclical BCBS capital and liquidity framework, or BASEL III (b) effective supervision – bringing all major financial jurisdictions under the regulatory umbrella, and addressing the dragon of shadow banking; (c) resolution and addressing the oversized risks arising from systemically important financial institutions – with focus on G-SIFIs and living wills. (d) transparent international assessment and peer review – such as periodic stress tests of the financial system and FSAPs (Financial Sector Assessment Programs).
14. **The major successes** of the G 20 in financial regulatory reform are in overseeing implementation of the new Basel III capital and liquidity framework, requiring the originators of securitized instruments to retain some skin in the game to reduce moral

hazard, bringing all major jurisdictions under the regulatory umbrella, listing and monitoring of G-SIFIs, monitoring of shadow banking, and mainstreaming macroprudential regulation, which had so far been largely limited to developing countries like India, to address procyclicality.

15. Its **Major Failures** to this date comprise the inability to regulate of Shadow banking, compensation practices, the regulatory divergence between Europe and the US, where there has been some rollback, and in addressing the pro-cyclicality arising from the mark to market mechanism, so eloquently underscored by Sheila Bair as Chair of the US FDIC. It is expected that macroprudential policies would address this pro-cyclicality. New financial technologies deriving from greater digitalization, accelerated by the Covid crisis, are new challenges that lie ahead in the area of financial regulation.
16. The G 20 itself was of the view that the robustness of its reforms in the area of financial regulation would be tested in the next crisis. This crisis is now upon us. The financial system has held up quite well so far, but the longer the Covid crisis lingers in the real sector, so will the stress on the financial system. The real test may well lie ahead. It may be recalled that the GFC emanated in the financial sector, and in the early stages there was some speculation that it might not spill over into the real sector. The Covid crisis on the other hand has emanated in the real sector, and it could spill over into the financial system with a lag through growing bankruptcies.
17. Looking back at my experience in the early years of the G 20, now as an outsider, I am struck by how much the big picture has changed. Global economic governance at that point was dominated by the G7. EMDEs were still seen largely as recipients of aid. However, trend growth stagnated and declined in AEs even as fast growth in Emerging Markets was a major driving force behind the great moderation leading up to the crisis. The relative weight of EMDEs in the global economy had risen sharply. Their growth was also much less affected in the immediate aftermath of the crisis. It was therefore felt that the bigger EMDEs, particularly China and BRICS, needed to be inducted as stakeholders in global economic governance. This was especially so since mounting global imbalances was seen as one of the major underlying causes of the crisis. The G 20 was the most compact multilateral forum for effective decision making that included the BRICS and other major EMDEs. At the Pittsburgh Summit the G 20 designated itself as the premier forum for global economic cooperation, effectively replacing the G 7.

18. With the sentiment turning against globalization in favour of economic nationalism – even as it continues apace in the real world, lower trend growth in EMDEs, the stronger recovery in advanced economies, and the decline in global imbalances, the G 20 appears to have lost some of its sheen and importance in recent years. Whether the G 7 will revert to its former leadership role is however arguable with dissensions within the G 7 on the one hand, and the rise and rise of China on the other. The G 20 remains the most effective extant institution to address challenges flowing from globalization. However, global cooperation of the kind seen at the time of the GFC over a decade ago now looks increasingly difficult in the current environment.

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