The euro and the Greek crisis: a new international monetary scenario

The global market requires an international currency that is managed beyond national interests and a disciplined common exchange-rate regime. The EU and the euro need urgent reform if the euro is to be a monetary heavyweight

By Paolo Savona, Guglielmo Marconi University, Rome

The 2007-09 crisis has taken one more victim: the euro. The collapse of confidence in Greece has the reduced credibility of the European Union. This is an expression of the weakness of the European institutional architecture. Surprisingly, the fall in the euro's value followed a period characterised by the belief that the euro would replace the dollar as the international reserve currency. Although some economists – and, indeed, some vested interests – insist this was largely inconsistent with prevailing political conditions, the conventional belief did not waver.

The euro area – with only 16 out of the 27 EU members – is not an optimal currency area from many points of view. It needs compensatory fiscal unification to share the risk for a common future. The rejection of the Lisbon Treaty sent a clear message of the EU's unwillingness to apply the same rules for every citizen in Europe.

Nonetheless, after having acquired sovereignty on competition policy and money management, the EU reinforced the role of the European Parliament. Yet it has been unable to coordinate fiscal policies, which remain in the hands of member states. Complicated decision-making procedures and ill will toward political unification limit the permanent success of the euro area and the possibility of the EU using all its potential geopolitical influence.

The Greek crisis has revealed deep political differences among EU members. These differences date back to the signing of the Maastricht Treaty. They grew after a long period of relatively low growth and the impact of the recent financial crisis on employment. The founding 'idea of Europe' lost its appeal after the great events at the end of the 20th century: the fall of the Berlin Wall and the rise of China and other emerging countries. The most influential EU members and the EU Commission itself revealed their inability to adapt treaties to the new geopolitical and geoeconomic changes.

> "The Greek crisis has revealed deep political differences among EU members"

Since the start of the 21st century the value of the euro has increased under the pressure of the conversion of the dollar made by countries with a fixed or pegged exchange rate regime, such as China and oil producers, that participate in global trade. This was the result of the United States abandoning the Bretton Woods agreement in 1971 without enforcing a common exchange-rate regime among the members of what is now the World Trade Organization (WTO). The EU did not understand that the euro needed a different external exchange rate regime – fixed or pegged, instead of floating – to protect itself from the conversion of the dollar-denominated official reserves of other countries into euros. This pushed up the euro's value, discouraging European exports, lowering the euro area's rate of growth and weakening the appeal of political unification among European citizens. The rejection of the Lisbon Treaty has been interpreted as a result of the poor economic performance of EU institutions.

The European Central Bank (ECB), however, was satisfied by the euro's strength, seen as evidence of the ECB's success in anti-inflationary management. The appreciation of any currency helps keep the rate of inflation down but raises the question of whether deflation can produce monetary success.

The ECB's monetary policy became paradoxical when the ECB (together with the European Commission) pressured China to revaluate the yuan-renminbi as requested by the United States. China firmly resisted, and the euro was saved from greater appreciation.

From this perspective, the drop in the euro's value as a result of the Greek crisis has helped the recovery of European exports. This new situation would allow a change in the Chinese exchange rate regime or an extension of the range of pegging the yuan without affecting the euro. And yet this contingent condition does not change the fundamental need for a true political organisation within the EU as a prerequisite for a strong euro. It is thus difficult to understand Germany's approach of creating a reserve currency by a country or an area with a balance-of-payments deficit. Having a strong currency is inconsistent with keeping a huge surplus in the balance of payments, as Germany does.

One concern with regard to the Greece bail-out is whether the EU should accept any intervention by the International Monetary Fund. The idea that the euro might seem a better reserve currency than the dollar is the result of a misinterpretation of the real needs of a well-functioning global market. A global market requires an international currency managed beyond national interests, as is the case with both the dollar and the euro. Free, asymmetric competition among national currencies produces gains derived from managing differing exchange rates. The different exchange rate regimes tear

apart the common rules of fair competition and lead to structural disequilibria in trade balances. Yet this issue is not on the global agenda, nor was it during the 2007-09 crisis and its Greek appendix. The appreciation of the dollar diverted the attention of policymakers from its instability and the poorly functioning international monetary system, both part of a more general problem concerning the international financial architecture still on the global agenda.

The possibility of speculation grew after the large diffusion of derivative contracts. Speculation no longer needs money since it has many new instruments in addition to the traditional, controlled monetary and financial instruments. The G20 promised a global legal standard to fight speculation, but the world is still waiting for it. To be effective, the new monetary and financial architecture should regulate all sectors in the same manner to avoid facilitating moves toward less regulated sectors (such as credit default swaps and hedge funds) instead of regulated ones (such as bonds and shares).

With regard to the EU, any attempt to regulate the euro without a parallel programme to regulate the dollar and differences in exchange rate regimes is destined to fail. European governments and regulators maintain that the euro is safe but that fiscal and wage discipline is required. As for the dollar, its regulators claim they can do nothing to control its supply or to force China – or any other country with a surplus – to change its currency regime. Perhaps they speak the truth. But it is not enough to avoid proposing a solution for improving the performance of world trade, and thus sustaining and enlarging growth.

Zhou Xiaochuan, governor of the People's Bank of China, has proposed expanding the creation of special drawing rights (SDRs) to allow a smooth substitution of the dollar as the international reserve currency. Such an agreement should be implemented by China shifting to a floating system in exchange for the guarantee of the value of its dollar-denominated official reserves. The United States cannot keep the dollar at the centre of the international trade system and continue to borrow from the rest of the world in order to keep a high domestic rate of growth. Eventually the dollar will collapse, as in August 1971. Its recent recovery is the result of a psychological reaction to the crisis – the view that the dollar was 'the worst currency except all the others'. But for how long? The market constantly produces monsters that kill the market itself to regenerate its rational role. If it does not perform this 'purification' process, things end up in the hands of the judiciary's power, as is happening now.

> “European governments and regulators maintain that the euro is safe, but that fiscal and wage discipline is required”

If the EU and the euro area cannot reform their institutional and constitutional architecture, they would benefit from implementing an international agreement on a new international currency, such as SDRs, together with a change in WTO rules: those countries that participate equally in the free global market must have the same exchange rate regime.

If so, the euro would grow stronger instead of being exposed, as it is now, to the perils of a stormy sea, just like a boat caught between the weakness of the dollar and the official reserves of countries with trade surpluses heavily reinforced by speculation. ◆

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Strategies for fiscal sustainability

The global economic crisis, from which the world's governments are still struggling to emerge, could not have come at a worse time. Saddled with immense stimulus-related debt that will be carried forward for years to come, the world's major economies are about to confront a second unsettling crisis – preparing for the costly needs of their aging populations. At risk is the fiscal sustainability of jurisdictions; yet, as KPMG International found in a recent survey entitled Tough Choices Ahead: The Future of the Public Sector, public sector leaders are not yet adequately engaged. The need for action is urgent, and the current relatively simple approaches to reforming the public sector in the past likely will no longer work.

The survey found that public sector leaders are well aware of the growing needs of the aging population, but they are not prepared to take immediate action. Although 60 percent of respondents said they intend to make long-term changes to prepare their organizations, only 20 percent of respondents are prepared to make the kinds of radical changes to their programs and services that will be necessary to provide service during a period of severe budgetary pressures. For the majority, traditional public service delivery simply isn't sustainable.

KPMG has developed a three-stage model that responds to the need to revolutionize the public sector. This revolution begins with a debate between the public and their politicians on what suitable roles government should have in public service delivery. Governments must be able to communicate and then demonstrate their commitment to cutting nonessential and inefficient programs and services.

As with traditional responses to the financial crisis, the plan begins with short-term cost reductions, then moves to medium-term improvements in efficiency, and a strategic transformation in program and service delivery. The responses are a familiar exercise for government administrators; they cut costs and provide a quick political boost, but they are at best a finite exercise. Eventually, they prove too painful for the public and politicians alike and must be curtailed. They are only buying governments time. Similarly, the medium stage-improvements to efficiency, such as sharing resources and reviews to human resources practices can offer longer-term results, but they still operate within a legacy of inefficient structures.

The ultimate stage is strategic transformation, as it is both far reaching and comprehensive, and also far more difficult to execute. It requires a reassessment of spending priorities, determining what government can do and do well, and what it needs to cut loose. It calls for a search for new sources of funding. With falling revenues, the public sector must look for funding in other ways, such as private finance initiatives, public-private partnerships, user fees, and sales of assets. It also must decide which services to outsource to the private sector and which to maintain, and it must communicate to the public the wisdom of doing so. The true measure of success in the public sector is effective outcomes from public expenditures, not the traditional notion that governments are always the best providers of public services.

Increasing public-private co-operation through greater degrees of collaboration, group accountability, and traction from an effective commissioning model – these are the tasks of strategic transformation. They are complex challenges and they demand leadership that views the enterprise from a system-wide perspective. Public sector leadership should bring disparate public and private organizations together to create change in a mutually beneficial manner. The time has come to hold a debate on major change. Concerns over global financial conditions; research demonstrating government willingness to change strategies; and openness among citizens to address their country's financial health all point to an overwhelming need to redefine the role of the public sector.

The public sector is destined to become more complex, requiring its management to synthesize a strategy based on complex information and drivers rooted in manifold and overlapping sectors. In short – strong, sophisticated leadership is one of the most important drivers in strategic transformation.

Strategic transformation is a responsibility that government cannot afford to put off. In a new era of declining conventional revenues, aging populations, and greater expectations, radical change is needed. It should address years of public sector growth and complexity, and it requires real political courage, but more sophisticated knowledge of how to execute a large-scale overhaul. At issue is the fundamental change in the role of the state; the time has come for deep, long-term fundamental change in public sector service delivery. The challenge is urgent; the response must be intelligent and orderly, but bold.

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Monte Carlo, Monaco: once considered a non-cooperative jurisdiction, Monaco has been removed from the OECD's 'black list'

By Amandine Scherrer, associate researcher, Canada Research Chair in Security, Identity and Technology, Université de Montréal

Offshore jurisdictions

In the wake of the financial crisis, the G20 crackdown on offshore jurisdictions and tax havens aims to strengthen and regulate the international financial system

In the declaration of the G20 Summit on Financial Markets and the World Economy at Washington in November 2008, the G20 leaders committed themselves to a range of medium-term actions, including the implementation of national and international measures that protect the global financial system from uncooperative and non-transparent jurisdictions. At its London Summit in April 2009, the G20 went further and announced a crackdown on offshore jurisdictions and tax havens. In their final communiqué, the G20 leaders endorsed sanctions against non-cooperative jurisdictions and boldly declared that the "era of banking secrecy is over".

This focus on tax havens and offshore jurisdictions has been presented as a way to strengthen and regulate the international financial system. Indeed, tax havens and offshore jurisdictions are places where trillions of dollars circulate every year. According to the World Bank, these places lead to massive fraud. Hundreds of billions of dollars are estimated to be hidden from tax authorities in offshore banks. Accused of being a haven for illicit finance, tax havens and offshore jurisdictions are also singled out for creating mistrust in investments and for destabilising financial flows and free market activities. Moreover, these jurisdictions shield two thirds of hedge funds that have come under fire since the 2008 financial crisis.

What was seen by many commentators as the major concrete achievement of the London G20 Summit has led to the publication of a renewed list of non-cooperative jurisdictions by the Organisation for Economic Co-operation and Development (OECD). It has three specific categories: jurisdictions that have substantially implemented the OECD standards are on the 'white list'; tax havens and financial centres that have committed to implementing these standards are on the 'grey list'; and those that have not committed to the standard are on the 'black list'. Since the publication of these lists, the only three jurisdictions considered as non-cooperative (Andorra, Liechtenstein and Monaco) have been removed, thanks to their efforts to implement the internationally agreed standards. Other countries on the grey list, such as Malaysia and the Philippines, have been removed on the same grounds. Even Switzerland endorsed the OECD standard and the end of banking secrecy. The shaming effect of the OECD list has worked.

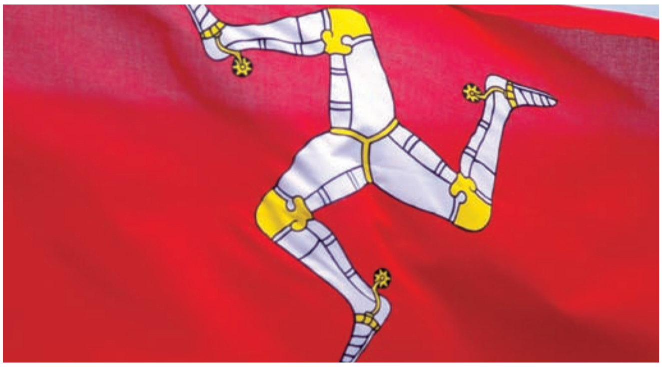
The G20 has also improved its regulatory mechanisms. In 2008, the G20 leaders transformed the Financial Stability Forum into the Financial Stability Board, with an expanded membership and a broadened mandate to promote financial stability. This new structure includes an expert group on non-cooperative jurisdictions. Moreover, through the Global Forum on Transparency and Exchange of Information, the G20 has enhanced the peer review process. According to the progress report on actions taken to promote financial regulatory reform, issued by the United States at the Pittsburgh G20 Summit in September 2009, even jurisdictions that are not members of the Global Forum, where appropriate, will be subject to the same review and invited to engage with the forum in the context of any review. Preliminary assessments from the peer review programme are expected by June 2010. The Global Forum will also submit a report on multilateral tax information exchange agreements (TIEAs) and the steps necessary to accelerate full implementation of the approved reforms.

Despite these achievements and the apparent consensus among G20 members displayed since the London Summit, problems remain. First, the G20 commitment to tackle these jurisdictions still fails to overcome the political challenges of identifying and targeting them. Territories such as Macau, Hong Kong, the Channel Islands and the Virgin Islands are still politically highly sensitive and have not been included on the OECD grey or black list, despite the fact that these jurisdictions share common features with well-recognised non-cooperative offshore jurisdictions and tax havens. This situation raises the issue of the comprehensiveness of the regulatory mechanism promoted at the international level, which fails to include territories linked to influential powers such as China, the United States and United Kingdom. Second, even though the regulatory mechanisms and the peer review system have been improved, the issue of sanctions is still a subject of heated debate among G20 leaders. Even if the G20 London Summit and the G20 Pittsburgh Summit were supposed to adopt a consensus on proper sanctions against tax havens that fail to sign new anti-secrecy agreements, no agreement has yet been reached. Therefore, even if the move for greater transparency seems to be durable and taken seriously, further work and improvement are needed. The G20 Toronto Summit in June 2010 will thus be the occasion for a substantive follow-up. The work of G20 leaders will benefit from the release of the Global Forum's preliminary assessments of the peer review programme and the report on TIEAs.

> "The G20 leaders should agree on a toolbox of countermeasures to pressure tax havens to comply"

Switzerland is one of the countries that has implemented the OECD standards

Among the issues to be tackled at Toronto, the G20 should encourage the expansion of the Global Forum's membership, which currently gathers 91 countries and territories. More jurisdictions should enter into agreements in line with the Global Forum's model agreement and article 26 of the OECD and United Nations models. The network of TIEAs also needs to be expanded. Moreover, even if the shaming effect of the OECD lists seems to be effective, a jurisdiction's mere declaration of intention for better implementation of OECD standards should not be a sufficient condition for its removal from the list. Proof of accountability and transparency should be displayed and monitored closely by the Global Forum. Furthermore, the OECD lists should be more comprehensive, consistent and credible, specifically regarding the current offshore jurisdictions and tax havens not yet included on the OECD list. Finally, as announced at the London Summit, the G20 leaders should agree on a toolbox of countermeasures to pressure tax havens to comply. For instance, the risks encountered by financial service firms if they intentionally use foreign centres to evade full reporting of their clients' accounts to the tax, customs and judicial authorities should be clarified. At the same time, those countermeasures should avoid using development aid as blackmail to force developing countries to commit to OECD standards. The Toronto Summit should thus be the occasion to reflect more carefully on how developing countries can be further integrated into and benefit from the work of the Global Forum. ◆



The Isle of Man: a responsible international neighbour

The economic uncertainty experienced in recent times has underlined the importance of international co-operation and the need for countries, large and small, to develop even closer working relationships.

Unity, openness and compliance with global standards, applied equally, are seen to be key elements if the world economy is to emerge from this unprecedented turbulence into strong, sustainable and balanced growth.

International collaboration is a cornerstone of the approach adopted by the Isle of Man, a self-governing British Crown Dependency centrally located in the Irish Sea between England, Ireland and Scotland. We have established a reputation for facilitating good business within a diversified economy while working with our global partners and regulatory bodies as a responsible international neighbour.

Our Island strives to be a model of political stability, transparency, financial regulation and supervision, and has remained at the forefront of efforts to tackle money laundering and terrorist financing. These attributes have been recognised by the IMF, for example, in a report published in 2009. A United Kingdom review of British Overseas Territories and Crown Dependencies acknowledged the Isle of Man as a well-regulated and co-operative jurisdiction with a sound and diverse economy able to cope with and adjust to global economic crises.

One of our major priorities has been responding to pressures from the international community on tax transparency and co-operation – an area in which the Isle of Man has long been a leader.

A decade ago, the Isle of Man helped to develop the OECD model tax information exchange agreement. Since then we have led the way in signing these agreements: from the United States in 2002, through the Scandinavian countries in 2007, to France and Germany in 2009, for a total so far of 15. In addition, the Isle of Man signed three comprehensive double taxation agreements in 2009. More of both types of agreement are currently under negotiation.

Our commitment to openness was recognised when the G20 met in London last year, with the Isle of Man earning a place on the OECD's 'White List' of countries complying with the global standard for tax co-operation and exchange of information.

Recognising that we need to continue to respond to evolving international standards, the Isle of Man has committed to moving to automatic exchange of tax information on savings, under the EU Savings Directive.

We have a track record of contributing to the debate on emerging global standards and we intend to continue to contribute as the debate moves forward on issues such as minimum rates of taxation. This is a matter which would be best advanced through discussion rather than coercion.

In parallel with our collaborative approach to taxation, the Isle of Man has also shown leadership in international engagement through our involvement in a major initiative to help small countries respond to the repercussions of the global financial crisis and improve aspects of their regulation and management of their financial sectors.

Our Government has made a significant investment into international development by playing a key role in delivering the Small Countries Financial Management Programme in conjunction with the World Bank, Commonwealth Secretariat, Small States Network for Economic Development and Oxford University.

The aim is to promote the sustainable development of small state economies and give them a more powerful voice within the international community.

As our track record clearly demonstrates, the Isle of Man is known for its innovation, professionalism and long-term policy of positive engagement with international initiatives and standards.

All countries have a responsibility to pursue global solutions to existing and emerging challenges, and we look forward to continuing to play our part in this process.

Hon J A Brown MHK
Chief Minister
Isle of Man

Convergence of accounting standards – can the different perspectives ever be reconciled?

In their first *Joint Quarterly Progress Report*[1] on the co-development of selected accounting standards, the IASB and the US FASB (collectively, the Boards) highlighted potential issues on two major projects – financial instruments and insurance contracts, due to different conclusions on certain important technical issues. The Boards also noted that "… addressing those differences in ways that foster convergence could affect the project timetable …".

With more than 110 countries either already applying International Financial Reporting Standards (IFRS) or having announced plans to adopt IFRS, and with the US Securities and Exchange Commission (SEC) committed to making a decision about adoption in 2011, the ramifications of non-convergence of accounting standards are potentially far-reaching. We spoke to Ruth Picker (RP), Global IFRS Leader and Danita Ostling (DO), Americas IFRS Technical Leader about why the convergence of accounting standards is important and whether the different perspectives of stakeholders in the standard-setting process can ever be reconciled.

What is the cause of the different conclusions on the two major projects and how might resolution be reached?

DO: The delay in the financial instruments project stems from the differing views and perspectives between the Boards about when fair value should be used to measure financial assets. The IASB favours a mixed measurement model,[2] whereas the FASB seeks a wider application of fair value. The Boards have acknowledged that these differences in opinion exist for a variety of reasons, primarily about the extent of use of fair value, but also the phased approach adopted by the IASB as compared with the comprehensive approach adopted by the FASB. However, Sir David Tweedie, Chairman of the IASB and Bob Herz, Chairman of the FASB, believe that, even if a single approach is not agreed upon, both Boards' proposals could provide sufficient information in banks' disclosures to enable a comparison to be made between US GAAP and IFRS reporting. The Boards have agreed to expose both approaches for public comment and the views of the users of financial statements are important when considering these differing approaches.

Ruth Picker
Global Leader
of IFRS Services

Danita Ostling
Americas IFRS
Technical Leader

"Convergence alone is neither sufficient nor sustainable in the long-term. We believe that all countries, including the US, should ultimately commit to adopting IFRS."

RP: The IASB has indicated that it does not intend to move away from the mixed measurement model in IFRS 9, which was developed in response to calls from existing IFRS adopters, particularly in Europe. The fair value approach proposed by the FASB is unlikely to gain much support in Europe. There is a concern that, by exposing the FASB's proposal, the IASB could be seen to be reconsidering IFRS 9 to increase the use of fair value and this will likely concern existing opponents to IFRS 9, especially in Europe.[3] However, we understand that this is clearly not the IASB's intention. On the contrary, we think that the FASB's proposals may be unlikely to gain wide support in the US and there is a possibility that IFRS 9's approach may be preferred by some US constituents. Ernst & Young has globally publicly supported both IFRS 9 and the mixed measurement model as a reasoned approach.

DO: Similarly, the Boards currently have divergent views on the measurement of margins (profit) in insurance contracts. These differences may demand more attention and consideration from the Boards, but I do not believe they are insurmountable.

[1] The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) agreed in their 2006 Memorandum of Understanding (MOU), to align certain of their respective accounting standards, such as revenue recognition and leasing, and to reach convergence on these projects. The MOU was further updated in 2008 and 2009. The aim is to achieve a single, globally-accepted set of high quality accounting standards by mid 2011. The financial crisis has resulted in increased calls for this goal to be achieved by groups such as the G-20.
[2] This would be either amortised cost or fair value, depending on an entity's business model and the nature of the asset as set out in IFRS 9 Financial Instruments.
[3] IFRS 9 has not been endorsed in Europe and opposition to it remains, as some consider that it increases the use of fair value.
[4] SEC, Release Nos. 33-9109; 34-61578, Commission Statement in support of Convergence and Global Accounting Standards.

Why is the convergence of accounting standards important?
DO: The US is a key and important financial market in the world's economy, and the US SEC has, for many years, promoted the view that a single set of high-quality, globally-accepted accounting standards would be useful. In this regard, the SEC also has strongly supported the efforts of the IASB and the FASB to align their standards, noting that successful completion of the convergence agenda would be a "significant accomplishment toward improving financial reporting for investors worldwide".[4] The convergence of accounting standards is seen by many in the US as a pre-requisite step towards developing a single accounting language. However, as we noted in our Point of View piece last year, convergence alone is neither sufficient nor sustainable in the long term. We believe that all countries, including the US, should ultimately commit to adopting IFRS. The US is the remaining major capital market that has not made this commitment. Existing IFRS adopters are growing increasingly frustrated with the US influence on the IASB, given that it has not formally committed to the adoption of IFRS.

RP: A single globally-accepted set of high-quality accounting standards would serve to improve the capital flows of global capital markets. Investors would be able to compare the financial statements of companies around the world and make informed decisions accordingly. This would improve the transparency of financial information and also address concerns and limit the potential for accounting arbitrage where the accounting rules of one country may provide for a more favourable accounting treatment than another.

"Ultimately, the governance of the IASB needs to ensure a balance between independence and accountability to all stakeholders."

DO: Multinational companies also can gain efficiencies when the parent and subsidiaries are able to report under the same accounting standards. Furthermore, the onset of the financial crisis and the political push by the leaders of the Group of Twenty nations (G-20) has served to add impetus to the convergence project as global leaders seek to improve financial stability.

Detractors have stated that the IASB is not independent and investor-oriented. What can the IASB do to address these concerns?
DO: The IASB's composition of members now has representatives from the major economies of the world, such as Europe, Japan, Oceania, China, India and Brazil, as well as the US. The Standards Advisory Council also has been set up to provide independent advice to the IASB on technical issues. In addition, the International Accounting Standards Committee Foundation (IASCF), the oversight body of the IASB, has revised the IASB's Constitution to introduce a three-year public consultation period on its technical agenda and identify investors as a target audience for financial information. The IASCF's Monitoring Board also was established to facilitate interaction with capital market authorities and ensure public accountability of the IASCF. The Monitoring Board recently agreed to review the governance of the IASCF and IASB, including its own composition. These are steps in the right

"For our part, Ernst & Young has been working to build the bridges between the different stakeholders, to encourage discussion and co-operation to achieve this goal."

direction to demonstrate that the standard-setting process is free from political interference and underpinned by appropriate due process that gives all stakeholders an opportunity to provide input.

RP: I would add that the IASCF and the IASB also recently launched an investor outreach programme to enhance investors' participation in the development of IFRS. However, the heightened scrutiny of other stakeholders, including prudential regulators and governments, has led to a greater involvement and desire to influence the standard-setting process. This desire to improve financial stability can cause conflict with the stated objective of an independent standard-setter. Ultimately, the governance of the IASB needs to ensure a balance between independence and accountability to all stakeholders.

With the differing views on two of the key joint projects and the fragile political environment surrounding IFRS, can the aim of a single set of accounting standards ever be reality?
DO: I think so. This brings to mind an analogy about the upcoming Football World Cup that Jim Turley (Chairman and CEO of Ernst & Young) made in a webcast in September 2009 – that a key part of the global appeal about the game of football is that a single common set of rules exists. Imagine how chaotic it would be if each country brought their own rules to a global tournament! There may be a different ball or size of goal posts, depending on which countries were competing. So, the case for a common accounting language is clearly compelling. How we get there is the challenge but I believe it is achievable.

RP: I agree and I think this is the right time, given that the calls for one accounting language are coming from numerous sources and that we have come so far in the journey. We now stand, closer than before, at the crossroads of possibly developing a single globally-accepted set of accounting standards. Some challenging steps in this journey still lie ahead and some will undoubtedly involve difficult decisions. However, I think, we now have a chance of a lifetime to make this happen. For our part, Ernst & Young has been working to build the bridges between the different stakeholders, to encourage discussion and co-operation to achieve this goal.

The role of Islamic finance in the post-crisis world

Excessive and imprudent lending was arguably the primary cause of the crisis that hit the global economy. Can Islamic finance help to restore market discipline?

By Ahmad Muhammad Ali, president, Islamic Development Bank Group

The international financial system has just come out of a serious crisis that has been far more severe than any experienced in living memory. It took more than $3 trillion in bailouts and liquidity injections by a number of industrialised countries to abate the severity of the crisis. This action has intensified the call for a new architecture to minimise the frequency and severity of such crises in the future. Can Islamic finance respond successfully to this call?

Primary cause of the crises

It is not possible to answer this question without first determining the primary cause of this crisis. The most important cause of almost all crises is excessive and imprudent lending by banks. Market discipline should be able to prevent banks from resorting to the unhealthy practice of excessive and imprudent lending, which is not only against their own long-run interest, but is also a primary cause of international financial instability. But market discipline has itself weakened.

Discipline is enforced by incentives and deterrents. In the financial system, these take the form of risk and reward. Risks must be controlled effectively for this purpose. Profit-and-loss sharing can make a valuable contribution to realising this objective. If it is removed from, or weakened within, the financial system, the system will fail to operate effectively. Since banks are assured of a positive return on their advances in the conventional interest-oriented financial system, they have an incentive to lend excessively. The more they lend, the higher their profit. This phenomenon gets a further boost from recent innovations such as credit default swaps (CDS), which provide insurance to banks against loan losses. Collateralised debt obligations might be desirable if they were not an instrument for wagering. In addition, there is the 'too big to fail' concept, which assures big banks that governments' central banks will come to the rescue.

The false sense of immunity from losses provided by these factors has contributed to a decline in market discipline, although such discipline is considered the pride of the market system. Banks do not evaluate loan applications carefully, which leads to an unhealthy expansion in the volume of credit and excessive leverage. The availability of excessive credit produces not only an unsustainable rise in asset prices and living beyond one's means, but also increased speculative activity. Unwinding later on causes a steep decline in asset prices, as well as financial frangibility and debt crises, particularly if accompanied by overindulgence in short sales. As Jean-Claude Trichet, president of the European Central Bank, says, "A bubble is more likely to develop when investors can leverage their positions by investing borrowed funds."

> "Banks do not evaluate loan applications carefully, which leads to an unhealthy expansion in the volume of credit and excessive leverage"

The sub-prime mortgage crisis

The recent sub-prime mortgage crisis in the United States is a classical example of excessive and imprudent lending. Securitisation or the originate-to-distribute model of financing played a crucial role. Collateralised debt obligations, which mixed prime and sub-prime debt, made it possible for mortgage originators to pass the entire risk of default to the ultimate purchasers who would have normally been reluctant to bear such risk. Mortgage originators did not, therefore, have adequate incentive to undertake careful scrutiny of the debt proposal. Consequently, loan volume gained greater priority over loan quality and the amount of lending to sub-prime borrowers, as well as speculation, increased steeply. 'Teasing' rates to attract unsophisticated borrowers boosted this phenomenon further. Ben Bernanke, chair of the US Federal Reserve System, observed that "far too much of the lending in recent years was neither responsible nor prudent. In addition, abusive, unfair or deceptive lending practices led some borrowers into mortgages that they would not have chosen knowingly."

Market discipline thus fell short. Even the supervisors did not perform their task effectively by not nipping unfair practices in the bud. The result was that several banks either failed or had to be bailed out or nationalised by the governments in the United States, the United Kingdom, Europe and elsewhere. This created uncertainty about the recovery of loans and rendered banks reluctant to lend. The consequence was a credit crunch, making it hard for even healthy institutions to find financing. There was a lurking fear of a prolonged recession. The timely intervention by governments and central banks with enormous injections of liquidity averted this.

When there is excessive and imprudent lending and lenders are not confident of repayment, derivatives such as CDS are used excessively to protect against default. The buyer of the swap (creditor) pays a premium to the seller (a hedge fund) for compensation in case the debtor defaults. If this protection had been confined to the actual creditor, there might not have been any problem.

> "Islamic finance should, in its ideal form, raise substantially the share of equity and profit-and-loss sharing in businesses"

However, hedge funds sold the swaps not to just the actual lending bank but also to many others who were willing to bet on the default of the debtor. These swap holders, in turn, resold the swaps. The whole process continued several times. The Bank for International Settlements estimated that in 2007 the total outstanding derivatives (including $54.6 trillion in CDS) rose steeply to $600 trillion, more than ten times the size of the world economy. While a genuine insurance contract indemnifies only the insured party, in the case of CDS several swap holders had to be compensated. This greatly accentuated the risk and made it difficult for the hedge funds and banks to honour their commitments. No wonder George Soros described derivatives as "hydrogen bombs", and Warren Buffett called them "financial weapons of mass destruction".

The Islamic financial system

One of the most important objectives of Islam is to realise greater justice in human society as stated in the Qur'an. Justice, however, requires a set of rules or moral values, which everyone accepts and faithfully complies with. The financial system may be able to promote justice if, in addition to being strong and stable, the financier also shares in the risk so as not to shift the entire burden of losses to the entrepreneur.

To fulfil this condition of justice, Islam requires both the financier and the entrepreneur to share the profit as well as the loss equitably. For this purpose, one of the basic principles of Islamic finance is 'no risk, no gain'. This should motivate financial institutions to assess risks more carefully and to effectively monitor the use of funds by borrowers. The double assessment of risks by both the financier and the entrepreneur should help inject greater discipline into the system and go far in reducing excessive lending.

Islamic finance should, in its ideal form, raise substantially the share of equity and profit-and-loss sharing in businesses. Greater reliance on equity financing has supporters even in mainstream economics. Henry Simons of the University of Chicago, writing after the Second World War, argued that the danger of economic instability would be minimised if there were no resort to borrowing, particularly short-term borrowing, and if all investments were held in the form of equity. More recently, Harvard University's Kenneth Rogoff has said that in an ideal world, equity lending and direct investment would play a much bigger role.

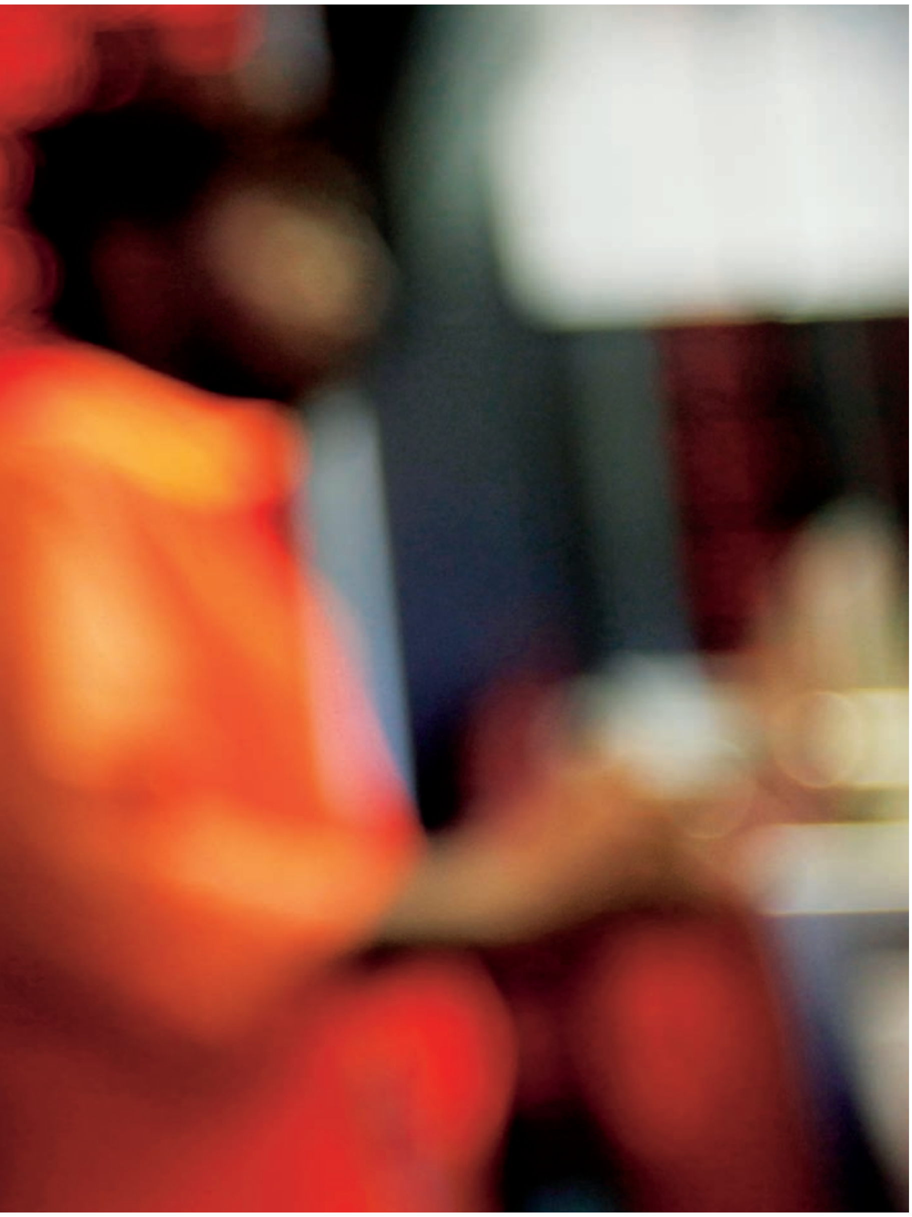
> Debt is indispensable but should not be promoted for non-essential and wasteful consumption

Greater reliance on equity does not necessarily rule out debt financing. This is because the financial needs of individuals, firms or governments cannot all be amenable to equity and profit-and-loss sharing. Debt is, therefore, indispensable, but should not be promoted for non-essential and wasteful consumption and unproductive speculation. For this purpose, the Islamic financial system does not allow the creation of debt through direct lending and borrowing. It requires the creation of debt through the sale or lease of real assets by means of its sales- and lease-based modes of financing (*murabahah, ijarah, salam, istisna and sukuk*). It has, however, laid down a number of conditions for the effective operation of these modes.

The first condition is that an asset being sold or leased must be real, and neither imaginary or notional. Second, the seller or lessor must own and possess the goods being sold or leased. Third, the transaction must be a genuine trade transaction with full intention of giving and taking delivery. Fourth, the debt cannot be sold and the associated risk must be borne by the lender.

That first condition helps eliminate many derivatives transactions that involve nothing more than gambling by third parties that claim compensation for losses suffered only by the principal party. The second condition ensures that the seller (or lessor) also shares the risk in order to get a share in the return. The seller (financier), on acquiring ownership and possession of the goods for sale or lease, bears the risk. This condition also constrains short sales, thereby removing the possibility of a steep decline in asset prices during a downturn. Shari'ah law has, however, made an exception to this rule in the case of *salam* and *istisna*, where the goods are not already available in the market and must be produced before delivery. Financing extended through Islamic modes can thus expand only in step with growth in the real economy and thereby helps curb excessive credit expansion.

The third and the fourth conditions not only motivate the creditor to be more cautious in evaluating the credit risk but also prevent an unnecessary explosion in the volume and value of transactions. This limits debt from exceeding the size of the real economy and releases substantial financial resources into the real sector, thereby increasing employment and self-employment and producing need-fulfilling goods and services. The discipline that Islam introduces in the financial system may not, however, materialise unless governments reduce their borrowing from the central banks to a level that is in harmony with the goal of price and financial stability.



Thus the Islamic financial system is capable of playing a stabilising role in the global economy by eliminating the major weaknesses of the conventional system and thereby helping minimise the severity and frequency of financial crises. By requiring the financier to share in the risk, it introduces greater discipline into the system. It links credit expansion to the growth of the real economy by allowing credit primarily for the purchase of real goods and services that the seller owns and possesses and the buyer wants. It also requires the creditor to bear the risk of default by prohibiting the sale of debt, thus ensuring a more careful evaluation of risk.

Islamic finance has been growing rapidly in recent decades. But it is still in its infancy and holds only a very small proportion of international finance. It has far to go before it attains maturity and starts reflecting the ethos of Islamic teachings. The use of equity and profit-and-loss sharing remains relatively small, while debt-creating modes remain preponderant. This is due in part to inadequate understanding of the ultimate objectives of Islamic finance, the non-availability of trained personnel and the absence of a number of shared or support institutions needed to reduce risks associated with anonymity, moral hazard, principal/agent conflict of interest and the late settlement of financial obligations. However, the system will gradually gain momentum and will effectively complement the current international efforts to bring health and stability to the global financial system.

Conclusion

The Islamic financial system is not something unique and unknown to the world of finance. It only represents an effort to revive some of the universally accepted principles of sound and healthy finance that have, in fact, been a part of the conventional system, but have gradually become weakened over the last few decades. This weakening has given momentum to the crises. Therefore, for the future health and stability of the global financial system, it is desirable for the conventional system to adopt the sound principles of its own heritage, which the Islamic financial system is trying to revive.

> “The Islamic financial system represents an effort to revive some of the universally accepted principles of sound and healthy finance”

Such principles of Islamic finance include the following: The proportion of equity in total financing must be increased to create a proper balance between equity and debt. Credit must be confined primarily to transactions related to the real sector to ensure that credit expansion moves in step with the growth of the real economy and does not promote destabilising speculation and gambling. Leverage must be controlled so that credit does not exceed the borrower's ability to repay.

Furthermore, if it is not desired to prevent the sale of debt in keeping with Islamic teachings, there should be full transparency about the quality of debt being sold so that the purchaser clearly understands the ramifications of the transaction. The ultimate purchaser of the debt should have the right of recourse, which would ensure that the lender has an incentive to underwrite the debt carefully.

Moreover, while there may be no harm in the use of CDS to protect the lender against default, they must be insured so as not to become instruments for wagering. Their protective role should be confined to the original lender and not cover the other purchasers of swaps who wish to wager on the debtor's default. For this purpose the derivatives market must be properly regulated to remove the element of gambling.

The compensation of bank management must be rationalised to safeguard against the taking of unnecessary risks. This rationalisation should, however, not deprive them of their due reward for their contribution to efficient and prudent management.

Finally, all financial institutions, and not just the commercial banks, must be properly regulated and supervised so that they remain healthy and do not become a source of systemic risk.

The adoption of these principles should put the international financial system on a sound footing and thus minimise the frequency and severity of crises. Nonetheless, prudent regulation and supervision remain important, and should continue to complement the greater discipline that must be injected into the system. ◆

Award-winning Islamic investment banking & finance house

Liquidity Management House for Investment K.S.C.C ("Liquidity House") is an investment company wholly owned by Kuwait Finance House K.S.C ("KFH") and is regulated by the Central Bank of Kuwait. Head quartered in the State of Kuwait, Liquidity House was established in December 2007 and commenced its operations in 2008 as KFH's international investment arm. The company was launched with a paid up capital of Kuwaiti Dinars 100 Million (approximately US$ 370 million).

Liquidity House through its vision to be a proactive and principal player in the International Sukuk Market and Shari'a compliant structured finance arena is committed to developing innovative Shari'a compliant structured finance products and services. Further, Liquidity House is committed to constantly providing customized solutions that caters to its clients ever changing and evolving needs.

Liquidity House current team has extensive experience within the Islamic Finance space and is a source of strategic strength. In addition to its team, Liquidity House derives its strength from KFH brand recognition, distribution capabilities and geographic coverage while offering its products and services to its clients.

Liquidity House is currently involved in various business lines as mentioned below;

- Capital Market & Securitization
- Corporate Finance & Advisory
- Syndication & Distribution
- Asset Management
- Direct Investment
- Sukuk Secondary Market Trading Activities
- Liquidity Management
- Discretionary Portfolio Management

Liquidity House is currently managing approximately US$ 1.5 billion as Assets Under Management as part of its discretionary portfolio management services which encompasses an array of diverse investments.

Within its nascent history, Liquidity House has emerged as one of the leading players in the Sukuk Arena. During the year of 2009 Liquidity House has successfully lead managed and book run various notable international deals such as the debut sukuk issuance for GE Capital Corp ("GECC") for which we won the Sukuk Deal of the Year Award for 2009 by Islamic Finance News Awards.

Liquidity House has also acted as one of the joint lead managers and book runners for the International Finance Corporation ("IFC"), private sector arm of the World Bank Group for its debut sukuk issuance. The aforementioned deal was awarded the Best Wakala Deal of the Year 2009 by Islamic Finance News Awards. At another instance Liquidity House was one of the Joint Lead Managers and Book Runners for Ras Al Khaimah sovereign sukuk issuance during the mid 2009. Liquidity House has already won various other awards and accolades by numerous international organizations.

Liquidity House also played a pivotal role in Corporate Finance and Syndication arena, where we successfully syndicated various deals despite the negative global market sentiments in 2008 throughout 2009.

Liquidity House is committed to the effective transfer of knowledge in the Islamic Finance arena and materialization of proper structures. We are equally committed to make the greatest possible difference to society using our expertise, resources, time and skills of our people all while professionally servicing the demands and needs of our customers.

Mr. Emad Al Monayea (Chairman & Managing Director) speaking at the first Islamic Conference in Russia

Mr. Ahmed Al Kharji (Senior Vice President) receiving the Sukuk Deal of the year 2009 award at the IFN

Social business and the G8/G20

Eradicating such world crises as poverty and hunger requires more than just good economics. Social business – business without personal gain – has a key role to play

Muhammad Yunus, founder of Grameen Bank, at a Grameen America open house, St. John's University, New York. The non-profit organisation provides banking services to entrepreneurs living below the poverty line

By Muhammad Yunus, founder, Grameen Bank; Nobel Peace Laureate, 2006

When the G8 was formed as a coalition in which each of the eight countries is among the most highly ranked exporters, there was great hope that these chosen eight would collaborate for the greater good of the globe as a whole. When this clearly did not work out well, the G20 was designed to represent the 20 countries that account for 85 per cent of the world's gross national product (GNP) and 80 per cent of its trade.

The result is a list of countries that have the power to alleviate social ills and poverty and, eventually, eradicate both. The G8 has the financial means, academic institutions and technology to share with countries that have been left behind during the great digital boom. The G20 has the scope to disseminate the human resources and markets necessary for poverty eradication. The G8 and G20 can join forces to eliminate the most denied human right of all: the right to not be poor.

Media coverage of the financial crisis gives the impression that, once this crisis is fixed, all the troubles will be over. But the financial crisis is only one of several crises that are threatening humankind. The world is also suffering a global food crisis, an energy crisis, an environmental crisis, a healthcare crisis and the continuing social and economic crisis of poverty. These crises are as important as the financial crisis, although they have not received as much attention.

Furthermore, media coverage may give the impression that these are disconnected crises that are taking place simultaneously, just by accident. That's not true at all. In fact, these crises grow from the same root – a fundamental flaw in our theoretical construct of capitalism.

The biggest flaw in the existing theory of capitalism lies in its misrepresentation of human nature. In the present interpretation, human beings engaged in business are portrayed as one-dimensional beings whose only mission is to maximise profit. This is a much distorted picture of a human being. Human beings are not money-making robots. The essential fact about human beings is that they are multidimensional beings. Their happiness comes from many sources, not just from making money.

Yet the theoretical framework of economics has built the whole theory of business on the assumption that human beings do nothing in their economic lives other than pursue their selfish interests. The theory concludes that the optimal result for society will occur when each individual's search for selfish benefit is given free rein. This interpretation of human beings denies any role to other aspects of life – political, social, emotional, spiritual, environmental and others.

No doubt, human beings are selfish beings. But they are selfless beings too. Yet this selfless dimension of human beings has no role in economics. This distorted view of human nature is the fatal flaw that makes such economic thinking incomplete and inaccurate. Over time, it has helped to create the multiple crises facing the world today.

> Grameen has launched different social business joint ventures that seek to fight malnutrition

> A charity dollar has one life, but a social business Bangladeshi taka has an endless life

Once this flaw is recognised in the theoretical structure, the solution is obvious. The one-dimensional person in economic theory can be easily replaced with a multidimensional person – a person who has both selfish and selfless interests at the same time.

Immediately, the picture of the business world thus changes. Now there is the need for two kinds of businesses, one for personal gain (profit maximisation), another dedicated to helping others. In one kind of business, the objective is to make the most economic gains for the owners, even if this results in nothing left for others. In the other kind of business, everything is for the benefit of others and nothing is for the owners – except the pleasure of serving humanity.

Let us call this second kind of business, built on the selfless part of human nature, social business. A social business is one where an investor aims to help others without taking any financial gain. At the same time, a social business generates enough income to cover its own costs. Any surplus is invested in the expansion of the business or in increased benefits to society. A social business is a non-loss, non-dividend company dedicated entirely to achieving a social goal. Regarding the source of funds, one source can easily be philanthropic money creating social businesses. This makes enormous sense. One problem of charity programmes is that they remain perpetually dependent on donations. They cannot stand on their own two feet. Charity money goes out to do good things, but that money never comes back. It is a one-way route. But if a charity can be converted into a social business that supports itself, it becomes a powerful undertaking. Now the money invested is recycled endlessly. A charity dollar has one life, but a social business Bangladeshi taka has an endless life. That is the power of social business.

In recent years, Grameen has launched different social business joint ventures that seek to fight malnutrition, including Grameen Danone, Grameen Veolia Water Ltd. and BASF Grameen Ltd. Additionally, in North America, it is conducting research on social business in healthcare together with Google, GE Healthcare, Pfizer and the Mayo Clinic.

In response to the G8's commitment to pledge $20 billion in aid for hunger relief, Grameen has developed a proposal to establish the Global Social Business Fund to End Hunger by putting 10 per cent of this money into the proposed fund. This initiative represents an unprecedented opportunity to introduce a new, more strategic solution to feeding the poor. The technological, academic and management contributions of G8 and G20 countries are crucial to the eradication of poverty. Instead of giving a dollar one life by giving it out as a charity, it can be given many lives through investing in social business. Now is the time to put poverty in museums. The technology is right. The desire for change is high. Social business must spread across the globe. What good is a wonderful seed if it is not scattered to the four winds? ◆

British Virgin Islands: A thriving economy

Premier, Honourable Ralph T. O'Neal

We welcome the opportunity to contribute to this publication as the G20 gathers for this important summit in Canada, to consider areas with particular relevance to the British Virgin Islands (BVI) such as financial sector reform, global trade and future growth.

The strength of the BVI is grounded in its internationally acknowledged standards of good governance, adherence to the principles of an established rule of law and low crime. Politically stable and self-governing, the BVI maintains a fully democratic system. We have adopted a new Constitution which allows for significant constitutional advancement and which ensures a role for the BVI Government in all issues which might directly impact on the Territory's populace.

The BVI has a thriving economy with low levels of unemployment. This originates from its successful management of the twin pillars of tourism and financial services. In both of these sectors the BVI has undertaken pioneering work. In tourism, close attention has been paid to ensuring that high quality, sustainable tourism is supported; from being a key destination for Caribbean cruises to being one of the world's sailing capitals, we welcome many thousands of tourists to our islands each year. Over the years we have invested time, effort and resources into developing a well-established infrastructure for the tourism industry and as the second crucial pillar of the BVI economy, tourism now accounts for 40% of annual revenue.

Our strength in tourism sits alongside the competitive success of our financial services industry, something of which we are all rightly proud. In the BVI we have an increasingly diversified financial services sector and we are widely regarded as operating a robust regulatory regime.

It is important that the G20, which can do so much to impact on global perceptions, is informed about our responsible approach as a cooperative member of the international community.

These building blocks of stability are reflected in how our economy has withstood the recent economic shocks. There is no room for complacency but we are firmly focused on securing our future through stability at home and our continuing engagement with relevant international bodies and institutions abroad.

Recent G20 summits have of course been focused on financial regulation and financial sector reform is a key theme of this G20.

There are five key principles that underpin the BVI financial services sector; regulation, collaboration, enforcement, transparency and expertise.

Regulation

The BVI is widely acknowledged as having a robust regulatory system which has been recognised by international bodies including the Caribbean Financial Action Task Force (CFATF), the International Organisation of Securities Commissions (IOSCO) and the OECD.

The BVI's high standards against money laundering and terrorism financing have been confirmed by the Financial Action Task Force's International Co-operation Review Group process.

In addition we have implemented a mixture of innovative and relevant legislation which, when combined with regulators and practitioners who are committed to remaining at the forefront of the industry, will serve to keep the British Virgin Islands at the cutting edge of financial services.

The Securities and Investment Business Act (SIBA), which has just been enacted responds to the requirements of IOSCO and enhances the BVI's attractiveness by establishing the right legal and regulatory framework for institutions, managers and investors. Also, the new Insurance Act ensures full compliance with the International Association of Insurance Supervisors' Core Principles; it simplifies the BVI's insurance regime and makes it even more transparent. Both new laws are aimed at strengthening our regulatory regime and ensuring we continue to be a jurisdiction of choice for doing business.

Collaboration

In line with the BVI's commitment to the OECD's principles for effective exchange of information and transparency, we have signed 17 Tax Information Exchange Agreements (TIEAs), with countries such as the UK, Australia, the USA, China, France, Ireland and the Netherlands.

We are also fully committed to signing further TIEAs as well as ensuring that TIEAs now signed with our OECD partners are effectively implemented.

The BVI is also on the Peer Review Group (PRG) which was formed at the OECD Global Forum on Taxation in Mexico in September 2009. The PRG is responsible for assessing the implementation of OECD standards in member jurisdictions of the Global Forum, and non-member jurisdictions, as well as ensuring there is a monitoring and assessment process which is universally applied to all finance centres. The BVI's framework is due to be reviewed in the first half of 2011, to which we are very much looking forward.

Enforcement

The BVI legal system's enforcement of robust and fair laws continues to attract high quality business to the territory. High profile prosecutions, such as that of IPOC, a Bermuda based mutual fund, and the establishment of the Financial Investigations Agency underline the Territory's commitment to effective enforcement. The BVI was chosen by the Eastern Caribbean Supreme Court (ECSC) as the jurisdiction to house the Commercial Division, opened in 2009, due to its reputation as the jurisdiction of choice for international commercial matters. The BVI has a legal and judicial system based on English common law principles, with ultimate appeal to the Privy Council in the UK.

Transparency

The BVI follows the principle that good business is built on honesty and integrity. Therefore, the BVI does not have, and has never had, a secrecy law nor does it have any legislation which institutionalises secrecy in any part of the financial regulatory process. The BVI subscribes to the common law principle of confidentiality while having in place avenues for accessing information for regulatory and law enforcement purposes including rendering assistance to foreign regulatory and law enforcement authorities.

Expertise

One reason for the success of the BVI as a financial services centre is the high level of cross sector expertise resident in the territory, supported by strict adherence to competency requirements. A strong relationship with the private sector enables the BVI to attract the requisite skills base from overseas as well as develop these skills from the local employment base.

The diversified financial services sector has been further enhanced by the award of Category 1 status to the BVI Shipping Registry and the creation of an Aircraft Registry.

The BVI boasts a relatively small population of 30,000 but we claim big hopes for the future. At home we are also focused on the continued development of high quality healthcare and education, as well as a robust environmental policy.

We have solid foundations, with a heritage of stable democracy and good governance. Through our deeds as well as our words, we have shown and will continue to show that we are a fully integrated participant in the international community.

As a Government we are committed to doing everything in our power to secure our futures – socially, environmentally and economically.

BRITISH VIRGIN ISLANDS
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The G20, the International Monetary Fund and global surveillance

Through its surveillance framework, the IMF aims to achieve strong, sustainable and balanced global growth

By Domenico Lombardi, president, The Oxford Institute for Economic Policy, non-resident senior fellow, Brookings Institution

At the G20 Toronto Summit, for the first time leaders will mutually assess their economic policies on the basis of the Framework for Strong, Sustainable and Balanced Growth, proposed by the United States at the Pittsburgh Summit in September 2009. Through this framework, leaders pledged to devise a method for setting objectives, to develop policies to support such objectives and to assess outcomes through mutual evaluation. The involvement of the International Monetary Fund (IMF) has been sought in providing analysis on various national and regional policy frameworks and how they fit together. The end goal is "strong, sustainable and balanced growth" in which the improvement of living standards in emerging markets and developing countries is meant to be a critical element.

On the basis of country submissions, the IMF has been asked to point out inconsistencies and incoherence in national assumptions, to evaluate the mutual compatibility of different country frameworks and policies, and to determine the aggregate effects of various national frameworks and policies on the global economy. After the initial phase of the mutual assessment process, which culminates with the June 2010 Toronto Summit, using data provided by the IMF, the G20 will devise a set of specific mutual assessment and policy recommendations that take into account not only policy implementation but follow-ups as well. Once the entire framework process is completed, in November 2010, following the Seoul Summit, it could then be fully implemented on an annual basis.

This exercise represents the first instance of multilateral surveillance on a global scale in recent history. It is characterised by two main innovations. To start, this is the first time the US has agreed – even proposed – to submit itself to a structured, full peer review process. In the case of the Jamaica Amendment, when the current IMF surveillance framework was discussed and approved in 1978, the US only reluctantly accepted its basic premise. The second novelty this time is the distinct shift from the previous practice whereby multilateral surveillance of the global economy was, in effect, handled within the closed circle of the G7.

Different from the narrow G7 membership (that is, the G8 without Russia), the G20 includes all the systemically important countries, such as the largest emerging Asian economies of China and India, as well as Korea and Japan. This expanded membership gives Asian countries an immediate and alternative platform for engaging with the IMF, which these countries still see as dominated by Europe and North America. The G20 was chosen, in fact, to integrate rising powers, mainly from Asia, into the multilateral system.

The G20-led multilateral surveillance poses some important challenges, however. One is that the exercise appears to be geared mainly toward raising awareness among national policymakers of the international spillover effects of their policies and providing a context in which they can exercise pressure. Whether this will bring about substantial revisions to national frameworks is uncertain, as it presupposes a common vision of the costs and benefits from coordination. Countries may have to change their policy stance in order to preserve the overall stability of the global economy, to accept higher risks by revisiting their precautionary reserve accumulation policy, or to revise their exchange rate policies.

G20 countries have so far all committed to a peer review process for their economic policies and to a broadly defined policy objective. This pledge does not mean that they have committed to numerical policy targets – consistent with quantitatively defined objectives set for the overall group – for which they can be held accountable in a multilateral forum. This situation is reminiscent of early IMF attempts, in the 1970s, to get systemically important economies to commit to a multilateral surveillance framework. Ultimately, these countries distanced

"G20 countries have so far all committed to a peer review process for their economic policies and to a broadly defined policy objective"

themselves from specific commitments. IMF multilateral surveillance became simply a forum for exchanging views and information on each other's economic policies.

An additional challenge refers to the IMF itself and to its role in the G20-led process. Like the G7, the IMF continues to enjoy an advisory function. Unlike with the G7, however, its advisory role is more clearly spelled out and, given the greater number of G20 member economies, is much more strategic. Still, it is not clear what an advisory role of this sort means for discharging critical tasks from its own mandate. The proposal from the US to grant the G20, and not the IMF, authority over the issue of China's exchange rate is a case in point.

In keeping with recent tradition, the IMF's executive board plays no part in formulating the organisation's advice to the G20. While it is true that many members of the G20 also sit on the board of the IMF and thus their involvement is guaranteed through their respective capitals, most of the executive directors do not just represent their nominating countries alone, but rather represent a group of countries. This added responsibility confers much greater legitimacy to each decision of the IMF's policy-making body.

Clearly, the dualism between the IMF and the G20 would disappear if the latter were to become a formal decision-making ministerial body within the IMF itself. This arrangement would have two distinct advantages: it would increase the legitimacy of the G20, as each member of the ministerial committee would also represent a number of other countries based on the constituency system that underpins IMF governance. And it would reassert the centrality of the IMF's role as overseer of the international monetary system, thereby providing the institution with unprecedented political impetus.

“IMF's executive board plays no part in formulating the organisation's advice to the G20”

This proposal has been put forward by a number of authoritative figures, including Tim Adams, former under secretary of the US Treasury, and Mervyn King, governor of the Bank of England. The *Fourth Pillar Report*, submitted to the IMF managing director in 2009 by a group of civil society organisations, has outlined a number of preconditions for such a reform to be feasible, including realigning voting power within the IMF membership, reconfiguring the composition of the executive board and establishing board constituencies with some basic accountability mechanisms that are currently completely absent. ◆

Unlocking human potential

Adequate nutrition for everybody.
There is a way we can help to improve the lives of millions of people around the globe. We can take steps to eliminate malnutrition, especially micronutrient malnutrition or «hidden hunger» by fortifying staple food regularly consumed by the majority of a country's population with micronutrients. Ensuring that people's diets contain adequate amounts of all the micronutrients they need would not only improve their state of health, productivity and learning abilities. It would make it easier for them to throw off the bonds of poverty as well.

Over the last few years, DSM Nutritional Products has built up the Nutrition Improvement Program team, which has taken an active role in the elimination of hidden hunger. Our team provides technical and scientific support for supplementation programs and for the fortification of staple foods with vitamins and minerals in developing countries.

The elimination of malnutrition is a key success factor in 6 of the 8 Millennium Development Goals.

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