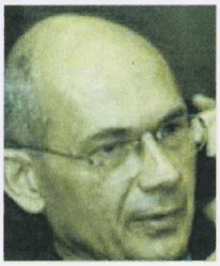
SPECIAL 38-PAGE SECTION

Global Governance is a challenge for democracy (but an EU opportunity)



Creating global governance mechanisms that are efficient but also responsive to national concerns will not be easy, says Pascal Lamy. But the WTO's Director General and former EU Commissioner sees useful lessons to be drawn from Europe

This new decade is marked by the worst-ever economic crisis that's also the first to have a global reach. The crisis has poured a good deal of cold water on the hopes and expectations created 20 years ago when the fall of the Berlin Wall ushered in an unprecedented era of economic openness and poverty reduction and a marked expansion of freedom, ideas, culture and technology.

The world today is in serious distress. Millions of jobs have been lost as a result of the economic crisis; we've also seen pandemics along with environmental problems, and this is impacting on millions of people in rich and poor nations alike. Nuclear proliferation, too, is on the rise, creating yet another of these global challenges that need global solutions. Our growing inter-dependence requires that the laws, social norms and values – all the mechanisms for framing human behaviour – need to be examined, debated, understood and operated together as coherently as possible. In sum, we need stronger and more effective global governance.

As with any system of power based on nation states, what is needed is "good" global governance; a system that offers a balance between leadership, efficiency and legitimacy, and which can ensure coherence.

Global governance poses a number of challenges. The first is the difficulty of identifying leadership at a global level. The second is legitimacy, and particularly what is often perceived as decisionmaking at an international level that is too distant, non-accountable and not directly challengeable. The third relates to coherence. In theory there should be no problem here because coherent action by a nation state in the various aspects of international governance should be translated into coherent global action. But we all know that nation states also have a monopoly on incoherence because in practice they often act incoherently. This is where the third challenge to global governance lies; how to deal with efficiency that is at times only partial and is also incoherent. And the fourth and final challenge is the remoteness of power and the multiple levels of government that also call efficiency into question.

Managing global problems by using traditional models of national democracy has important limitations. And yet the very credibility of our national democracies is at risk if global governance fails to establish its own democratic credentials because citizens around the world feel that the issues that affect them daily aren't being adequately dealt with.

Global governance poses a number of challenges. The first is leadership, the second legitimacy and the third coherence

In these troubled times for the European Union, it is no easy matter for it to present itself as a new paradigm of global governance. Yet the European construction is one of the most ambitious experiments to date in supranational governance, and the way Europe has coped with the sort of challenges I've just outlined is a useful reminder that defined and organised inter-dependency among nation states is perfectly possible.

The building of Europe is a work in progress, and the European paradigm is itself very specific to the conditions and pressures that prevail in Europe. Our continent was ravaged by two world wars and by the holocaust, leaving millions of men and women dead and many more millions in search of peace, stability and prosperity. One should therefore be cautious about ascribing universal values to what so far has only been a part of our European world. Other paradigms emerging elsewhere in the world reflect different conditions elsewhere.

At the heart of the European project has been the creation of a space of pooled sovereignty, a space in which the EU's members agree to govern among themselves without having permanent recourse to international treaties. The essence of the European governance paradigm is the coming together of national political wills to act together in the framework of a common project and an institutional set-up that can make it work. It's the combination of these three elements rather than just the governance methods used.

There is also the fact that Community law takes precedence over national law, and then there's a supranational body like the European Commission that has been given the monopoly of initiating legislation. There is also the EU's Court of Justice whose decisions are binding on national judges, and a parliament composed of a "senate" of member states, the council of ministers, and a "house of representatives" elected by the European demos, the European Parliament.

Taken together, these are the things that make the European Union a radically new economic and political entity when it comes to international governance. But today's EU could never be the product of these innovations alone. Indispensable and indisputable though they are, those institutional innovations are still inseparable from the conditions from which they emerged. It is agreement on the substance that permits agreement on the form.

I believe that the construction of the EU internal market, the European Monetary Union and trade policy are all areas where European integration has scored above average. The fact that the European Union numbers 27 member states and around 500m citizens, represents over a quarter of world trade and accounts for the world's largest GDP – and on trade speaks with one voice – gives Europe the capacity to defend its vision of trade opening accompanied by rules.

On the environment, Europe has played a global leadership role that reflects the large consensus existing within the EU on the need to protect and preserve the environment. Yet the institutional set-up within which Europe acts, the mixed competences and different voices, prevent Europe from being as effective in this area as it might, with the recent climate change summit in Copenhagen a warning. But it's an area where Europe still has a chance to break even.

In my view there are two other areas where Europe is not punching its weight in the world. On development aid, the EU is the world's largest donor and its flag can be seen at almost every major humanitarian crisis. Europe's aid effort is backed by strong public support, with some 72% of Europeans polled recently in favour of honouring or going beyond aid commitments to the developing world. And yet for all that Europe has so far had only a limited influence on setting world development policies.

The second problem area is the Common Foreign and Security Policy. The good news is that European citizens demand more and better foreign policies from Europe. But this also touches on one of the areas where symbolic barriers – those of dreams and nightmares, of collective identities and myths – remain powerful. It's why I think that building a European foreign and security policy requires a permanent compromise between interests and values. The EU's new High Representative for Foreign and Security Policy, a Vice-President of the European Commission who now chairs the General Affairs Council is a step in the right direction. But it will also take a common will to act together and a common concept, a sort of shared project, to get there.

There are a number of lessons that we can draw from more than 60 years of European integration

There are a number of lessons that we can draw from more than 60 years of European integration.

The first is that institutions alone cannot do the trick. Neither can political will without a clearly defined common project. Nor can a well thought through common project deliver results if there is no institutional machinery. The reality is that we need the three elements together to create an integration dynamic.

Even if these three elements are present there is a risk that a real or perceived legitimacy problem remains, creating a glass ceiling for further integration. The reality is that supranational institutions like the European Union require a long-term investment that is often incompatible with the short-term attention span of many of its leaders, who are often elected on thin majorities or with fragile coalitions. Global legitimacy requires long-term care and attention.

Governance systems can be likened to the three states of mass. The national level represents the solid state, the international system is more like gaseous mass and in-between these lies the European integration process as a kind of liquid state. But whatever the state of the mass, to make a governance system work demands a combination of political will, capacity to decide and accountability. In this respect, European integration offers some useful lessons for global governance.

Supranational institutions like the European Union require a long-term investment that is often incompatible with the short-term attention span of many of its leaders

Lesson one is the importance of the rule of law and of enforceable commitments. Global governance has to be anchored in stakeholders' commitments and in rules and regulations with mechanisms that deserve respect. This is at the heart of the post-war multilateral trading system, which has developed over 60 years of trade regulation among nations and has a binding dispute settlement system to ensure compliance with its rules.

It's also at the heart of what the international community is trying to do on climate change – achieve a multilateral deal where nations commit to emissions reduction accompanied by measures to facilitate adaptation and mitigation. And it is what the international community is striving to achieve on nuclear non-proliferation. It is true, too, for the regulation of finance, as the financial crisis so clearly demonstrated.

Commitments that are anchored in a multilateral context, and that can be monitored accordingly, allow for greater efficiency and coherence.

The second lesson for global governance is respect for the principle of subsidiarity; the international system should not be overburdened with issues better dealt with at local, regional or national level.

The third lesson is that "coherence starts at home" because it lies first and foremost with the members of international organisations. Take the United Nations; we can and must have the "UN Delivering as One", but we also have to see "UN members behaving as One" in the different organisations that make up the United Nations family.

The last of these lessons is that since the political demos remains essentially national, the legitimacy of global governance would be greatly enhanced if international issues become part of domestic political debates. National governments need to be held accountable by their voters for their international level behaviour. Democracy at the national level has to have more of an international dimension to foster legitimacy at the global level. The fact that the governments which represent states in international organisations are the result of citizens' choices through domestic elections is not in itself enough to ensure those international organisations' legitimacy. More is needed, so national actors – whether political parties, civil society, parliaments or citizens – must ensure that global level issues are discussed.

The good news is that many of these issues are already works in progress, so we need not expect a big bang. The global economic crisis has accelerated the move towards a new architecture of global governance in what I think of as the "triangle of coherence". On one side of the triangle lies the G20, replacing the former G8 to provide political leadership and policy direction. On another side lie the member-driven international organisations that provide expertise and specialised inputs such as rules, policies and programmes. The third side of the triangle is the G192, the United Nations that is the global forum for accountability.

The global economic crisis has accelerated the move towards a new architecture of global governance ... We should have both the G20 and the international agencies reporting to the "parliament" of the United Nations

In the longer term, we should have both the G20 and the international agencies reporting to the "parliament" of the United Nations. A revamping of the UN's Economic and Social Council could lend support to the recent resolution adopted by the UN General Assembly on a UN-wide coherence system. This would constitute a potent mix of leadership, inclusiveness and action to ensure coherent and effective global governance. With time, the G20 could even be an answer to reforming the UN Security Council.

A structure of this type needs to be underpinned by core principles and values, and this is precisely what Germany's Chancellor Angela Merkel proposed with the creation of a Charter for Sustainable Economic Activity. It is a commendable effort to provide a "new global economic contract" that would anchor economic globalisation on a bedrock of ethical principles and values, and so renew citizens' trust that globalisation can work for them.

Globalisation poses a serious challenge for our democracies, and our governance systems must respond to that. If our citizens feel that global problems are insoluble, that will risk emasculating our democracies. The same will hold true if our citizens see that global problems can be addressed, but that they themselves have no influence on the result.

Our governance systems must more than ever offer citizens avenues for shaping the world they want their children to inherit. And the European Union remains the laboratory of international governance, a place where the new technological frontiers of international governance are being tested. □

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Global governance could take a leaf from the EU's book

Everyone knows that international policy co-ordination would be of benefit to all, but what structures, what mechanisms? Iain Begg looks at some of the EU devices that could help shape global governance thinking

In an increasingly inter-connected global economy, the actions of one government have repercussions for others. Co-ordination among them matters a great deal, yet it is hard to achieve because what is in the common interest, especially in the short-term, does not always makes sense for any single country, especially in times of crisis when governments are under intense political pressure to 'do something'.

Around the world, governments have, on the whole, accepted that overt protectionist policies are ultimately counter-productive, despite the temptations that arise in a severe downturn. But they are less willing to see other policies in the same light and the current crisis has revealed shortcomings in mechanisms for assuring co-ordinated policy action at the global level. After the collapse of Lehman Brothers, it rapidly became clear that governments lacked an effective international toolkit for this, and as a result anarchy could well have broken out.

Governance arrangements that facilitate co-ordination offer a number of clear-cut advantages. Burdens can be shared, inconsistencies and incoherence in policy stances can be avoided, and participating governments' collective response can be far greater than the sum of the parts. Co-ordinated policy also makes it less likely that any single country will be picked-on by financial markets, or that a domino effect is engendered that might lead to a vicious circle of defensive policy reactions.

Why then is co-ordination so difficult to achieve? One obstacle is that countries have different priorities that can affect their willingness to commit to specific policy orientations; another is that the incentives to be a free-rider are often sizeable – why risk your own public finances if someone else is willing to risk theirs? But often the problem is simply that the institutional mechanisms that could enable better co-ordination are not in place, a problem that can be exacerbated when the crisis for which co-ordination might be the answer is unanticipated and unfamiliar.

The financial and economic turmoil of the last two years has obliged governments when constructing policy responses to learn by doing. This has inevitably given rise to mistakes and misunderstandings, such as some of the immediate actions taken to protect national banking systems from the shockwaves of the Icelandic bank meltdown in 2008. This had the effect of passing the hot potato to the next in line,rather than providing a sound solution. Despite the difficulties in orchestrating rescues of financial intermediaries, especially those with significant levels of cross-border activity, there are some examples of successful co-ordination that nevertheless stand out. The world's leading central banks engineered a 50 basis point cut in interest rates in October 2008 and, albeit somewhat haphazardly, the major economies put together national stimulus packages that de facto became a co-ordinated fiscal stimulus strategy.

The real advantage would come in times of economic crisis where a co-ordinated response should help to mitigate the burden on any single country and assure a credible collective solution

What these examples reveal is that although a co-ordinated outcome was eventually achieved, it was cobbled together rather than created by design. The main institutional forum for the key decisions is now the G20, but before that it was the G8, the G7 and other configurations, meeting infrequently and with no effective executive or administrative back-up. As a highly integrated region, the EU has had to confront the challenges of co-ordination and has developed a number of over-lapping mechanisms. These include the Stability and Growth Pact (SGP) for the 16 eurozone members that is intended to curb irresponsible fiscal policies, the Lisbon strategy aimed at promoting economic reform and other mechanisms for achieving specific goals like social cohesion or shared energy policy objectives.

These various EU mechanisms reflect different motivations. First there is that of imposing discipline on what should be avoided, what should be encouraged and the role of co-ordination commitments in reinforcing governments' implementation of unpopular measures, especially where there are vested interests. Another, less well-recognised motivation is stimulating policy learning to facilitate the adoption of improved policy. This can be achieved by exploiting ideas and practices from other countries, and is most likely to work well when there is a supportive governance framework.

All the EU co-ordination processes have their detractors and could undoubtedly work much better, but they provide a possible basis for the development of co-ordination as part of global governance reform. That makes the distinctive principles behind these EU approaches worth exploring. The rationale for the SGP is to deter and penalise fiscal policy behaviour that has potentially adverse ramifications for other eurozone countries. The SGP solution was to impose rules backed by sanctions which, though widely regarded as rather toothless, arguably had a moderating effect on national excesses – at least until the onset of the present crisis.

Could such a commitment device be envisaged at global level, and how might it be organised? The essence of the SGP is the rule that public finances should be kept within the prescribed limit of a 3% deficit, and should aim for balance over the medium-term, but with more flexibility in times of recession. When the original SGP was adopted in 1997, its critics objected to the simplistic nature and inflexibility of the policy rule and its dubious economic rationale, while non-compliance by Germany and France in 2002 raised doubts about its effectiveness. The pact was then reformed in 2005 to make it more flexible. Although the European Commission is responsible for surveillance of member states, a decision on whether to instigate disciplinary measures is taken by Ecofin, the body bringing together all the national finance ministers. The disciplinary measures theoretically include the eventual imposition of a fine on countries that fail to rein in deficits, but in practice the principal weapon is naming and shaming.

In a severe downturn, speed of action and appropriate sequencing are essential and, although the actions taken by the G20 did eventually stabilise the world economy, vital time was lost and the recession was aggravated

In principle, the IMF, too, has a duty to engage in surveillance of economies and could be assigned a similar role in implementing agreed fiscal rules alongside the more robust Financial Stability Board agreed by the G20 last April. The latter's mandate, though, is mainly to police the financial sector, so it might be better to consider a new, multilateral Fiscal Stability Board. Although, the notion of sanctions in the form of fines at a global level is even more far-fetched than in the EU, the scope for naming and shaming is still considerable. And the IMF can also exercise some influence through the conditions it attaches to loans. In good times, the incentive for governments to comply will come principally from financial markets, which can be expected to penalise those that depart too much from agreed targets.

But the real advantage would come in times of economic crisis where a co-ordinated response, embodied in transparent targets that are mutually consistent, should help to mitigate the burden on any single country and assure a credible collective solution. In a severe downturn, speed of action and appropriate sequencing are essential and, although the actions taken by the G20 did eventually stabilise the world economy, vital time was lost and the recession was aggravated. However, the gradual reversion to business as usual will pose a sterner test, because the recession's depth differs from country to country. The central bank money sloshing around the system will eventually have to be mopped-up and fiscal policy tightened. But if done in an unco-ordinated or, worse, incoherent manner, the effect could be to trigger precisely the sort of W-shaped double-dip recession that many fear.

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The Lisbon strategy's approach is more distinctive and promising, yet harder to relate to conventional thinking on co-ordination. It consists of the articulation of common goals and guidelines, the development of national reform programmes aimed at advancing economic reform, and an iterative process of scrutiny and evolution in these reform programmes. It has been criticised for its unrealistic ambitions and rhetorical flourishes that are belied by timid policy action, for its lack of incentives or enforcement mechanisms, and for being tangential to real policymaking. But its bad press has been exaggerated. Almost subliminally, the strategy has had an impact that is visible in the many shifts in national priorities and the adoption of new directions in policymaking.

In contrast to the SGP's focus on what countries should or should not do, the Lisbon approach is to stress what they could do by being sufficiently receptive to different influences. It seeks to achieve this by creating templates for good policy, providing a pool of ideas, fostering exchange of experience and establishing mechanisms like peer review and benchmarking that can help to identify better solutions to policy problems.

Could something similar be constructed at global level? The OECD already provides some co-ordination through its Going for Growth initiative, which tries to influence structural policies, but this is confined to its richer country members and has limited provision for policy learning. The expertise of policy advisers in the global institutions could also play a part, but what is missing are suitable international fora or specific mechanisms to promote policy learning. Nevertheless, by drawing on these sources it would be possible to develop guidelines similar to the Lisbon ones. To overcome the inevitable resistance of governments to being told what to do, an incremental approach probably makes good sense. A first answer could be to experiment with some of the low key approaches employed in the EU, such as setting targets, mutual surveillance and thematic seminars. More elaborate structures might subsequently be envisaged, including a role for constructive scrutiny by international agencies and some sort of global policy learning agency.

Effective co-ordination is never going to be easy, but that should not deter us because the benefits are simply too great to ignore. □

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The *Europe's World* panel on global governance

For our global governance scorecard, a panel of 26 top political and economic analysts gave their opinions on the need for reform in global institutions. This mini-survey threw up some surprising results, and above all emphasised that top analysts can be thoroughly divided on these issues.

Most agreed that leading global institutions like the International Monetary Fund, the World Trade Organisation and the UN Security Council need reform. Of 26 analysts, 17 stated that the WTO needs to change, and 19 said the same of the UN Security Council. An overwhelming majority of 21 out of 26 believe that the IMF needs reform and seven of them think that reform should be "radical".

When it came to other institutions, particularly the UN agencies, opinion diverged widely. Half said that the United Nations Development Programme should be reformed, but only 16% thought that the reform should be radical, while 50% said no reform at all was needed. The panel also disagreed on other UN agencies like the Food and Agricultural Organisation, the World Health Organisation, UNESCO and the World Intellectual Property Organisation," 45% said that UNESCO needs reforming, but only 17% thought its reform should be radical. On whether new global Institutions are needed, opinion was again divided. Over three-quarters of the panellists thought that an international climate change agency is needed, but only slighty over half see a need for a carbon tax global co-ordination authority. A large minority of 11 out of 26 thought there is a need for an international derivatives and hedge funds authority. □


JOAQUÍN ALMUNIA
European Commissioner for Competition Policy


JAN KRZYSZTOF BIELECKI
President & CEO, Bank Polska Kasa Opie and former Polish Prime Minister


DANIEL DAIANU
former Romanian Finance Minister


JOVAN DONEV
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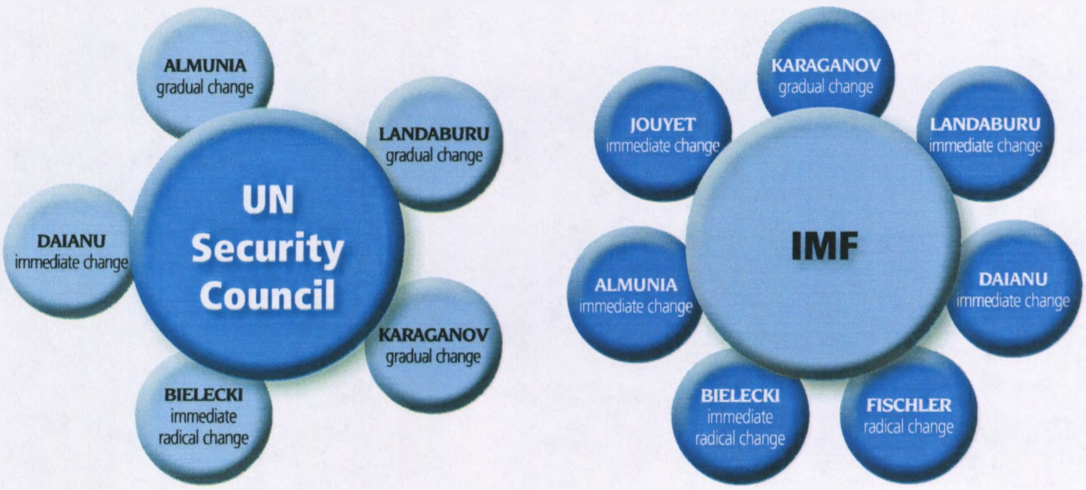
RIPE FOR REFORM?

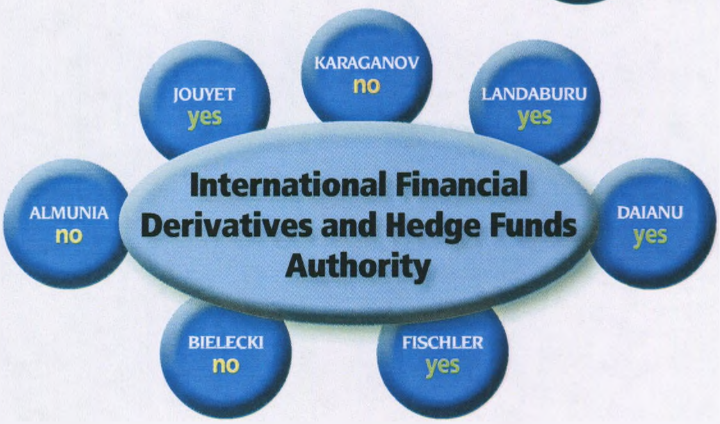
	Degree of Change		Timing of Change	
	Reform[1]	Radical[2]	Gradual	Immediate
UN Security Council	73%	37%	42%	33%
World Bank	83%	21%	37%	37%
IMF	80%	26%	16%	66%
UN agencies				
Development Programme (UNDP)	50%	16%	29%	16%
Food and Agriculture Organisation (FAO)	58%	21%	29%	21%
High Commissioner for Refugees (UNHCR)	37%	17%	21%	8%
World Intellectual Property Organisation (WIPO)	37%	12%	17%	12%
Industrial Development Organisation (UNIDO)	45%	17%	17%	17%
Educational, Scientific and Cultural Organisation (UNESCO)	45%	17%	29%	12%
International Labour Organisation (ILO)	50%	8%	33%	8%
World Health Organisation (WHO)	45%	8%	33%	17%
G20	70%	17%	50%	17%
Financial Stability Forum	45%	17%	17%	33%
BIS	33%	8%	17%	12%
WTO	63%	12%	45%	17%
OECD	62%	4%	45%	8%

[1] % of all panellists favouring some degree of reform
[2] % of all panellists urging radical reform



NEWCOMERS WE NEED?

	YES	NO
International Climate Change Agency	79%	21%
Carbon Tax Global Co-ordination Authority	58%	42%
International Financial Derivitives and Hedge Funds Authority	62%	38%



C. Fred Bergsten

Director of the Peterson Institute for International Economics

"The global crisis has accelerated governance reform"

The current global economic system was constructed in the middle of the 20th century, and could not be expected to fit the realities of the 21st century. The most fundamental change is in the composition of economic capability, and thus systemic responsibility, among the major countries.

Emerging and developing countries now account for 50% of the world economy when national output levels are converted at purchasing power parity (PPP) exchange rates. They are growing two to three times as rapidly as the rich countries, so every year their share of the global market rises by one or two percentage points. Soon they will constitute a substantial majority of global output, even with their GDPs converted at market exchange rather than PPP rates.

The global governance structure can only achieve political legitimacy, and thus substantive effectiveness, if it accurately reflects these realities. An historic step forward is the replacement of the G7/8 as the steering committee for the world economy by the G20, half of whose members are emerging markets.

More informal but functionally equivalent reforms have taken place in the governance of the World Trade Organisation. Its *de facto* co-ordinating committee now includes Brazil, India and sometimes China as well as the traditional "trade G2" of the European Union and United States along with Japan.

Similar changes now need to be made at the International Monetary Fund. At least 10% of the quotas and voting rights, and at least five of the 20-24 seats on the Executive Board need to shift primarily from over-represented Europe primarily to under-represented Asia. Even more important, both substantively and symbolically, is that the next Managing Director should be selected from an emerging market economy.

The global crisis has accelerated governance reform in all these institutions. That momentum must now be sustained and completed if the new economic order is to both prevent future crises and provide ongoing prosperity and stability for all. □

Daniel Daianu

Former Romanian Finance Minister

"G20 could turn into a global economic security body"

The G20 is the right instrument for our times, as it fits the extraordinary redistribution of economic power we are seeing in the world. And G20 could also turn into a global economic security body as that would enable it to hook up with the UN, where India and Brazil should become permanent members of the Security Council.

A re-suscitated IMF should usher in a re-working of principles and decisionmaking, as they affect international financial institutions (IFIs), and that would certainly be in tune with today's increasingly multi-polar world and the "wake up call" that is the current economic crisis. The IFIs should for their part return to John Maynard Keynes' vision of the Bretton Woods rules he helped create in 1944 that the inherent instabilities of financial markets must be reined in if we are to foster economic growth and international trade.

The policy mismanagement that helped create global imbalances, along with market failures of global significance, have to be tackled by a common global governance structure. As to the EU it needs to be much more cohesive internationally if it is to be an equal partner of the U.S. and China in the daunting challenge of dealing with climate change and other global threats.

Kemal Derviş
Director of the Brookings Institution's Global Economy and Development Programme and former Administrator of the United Nations Development Programme

"G20 should increase the legitimacy of the international institutions"

The great crisis of 2008-2009 has led to one major change – and thus to progress – in global governance; the G20 replacing the G7 as the premier international forum for discussing global co-operation. The London and Pittsburgh G20 meetings built confidence, proposed an increase in the war-chest of the IMF at a critical time and contributed to rebuilding the confidence shattered by the worldwide financial collapse.

The proposals made were broadly adopted at meetings in Istanbul of the World Bank and IMF, with the specifics awaiting more work, particularly when it comes to the significant shift towards emerging countries needed in voting weights and to the mechanisms of multilateral macroeconomic policy co-ordination.

The recent sequence of events should remind us that an informal meeting of leaders, even when they represent the most important countries, cannot replace the governing bodies of the international institutions of the UN system, including the IMF and the World Bank. Global co-operation requires burden sharing and co-ordinated action within the framework of these institutions.

Progress on issues such as long term financial stability, climate protection, effective control of infectious disease and the peaceful management of nuclear energy depends on how the G20 will be able to provide leadership, while recognising that all nations and peoples must have a say and must be part of a legitimate international system.

Jiří Dienstbier
Chairman of the Czech Senate's Foreign Affairs Committee and former Foreign Minister

"Nation states cannot meet the challenges of deregulated globalisation"

The legal, economic, financial and taxation instruments that have long been developed by nation states are in no way sufficient to meet the challenges of deregulated globalisation.

Some problems – notably terrorism, development and environmental issues – can be resolved only at a global level.

Others must be adressed by regional groupings like the EU, or within the nation states at regional or municipal levels. This sort of model will in any case be permanently tested by the changing global environment as well as by the ambitions of the players both on the world scene and at home as they struggle for political influence and power. The important thing is that we should aim to better understand the hierarchy of the problems we face, and that we should define and respect the levels at which they need to be tackled. An example of this could be the longstanding proposal by Jacques Delors to create a UN Economic Security Council. The message we need to draw from the phenomenon of globalisation is that we need more effective global tools and institutions. □

William Drozdiak
President of the American Council on Germany

"An alternative is regional institutions to act in the service of global governance"

The quest for effective global governance needs to focus on pragmatic models, not on utopian visions. The United Nations has made some very real contributions in peacekeeping, health and development over the last 65 years, but will never live up to the grandiose dreams that some have had of world government. The more salutary ambition would be to re-shape existing multilateral institutions in ways that harness the forces of globalisation while respecting the reality of nationalism as the dominant force in terms of power and order around the world.

The most successful reform so far has been the dramatic shift in global economic power from the G8 group of industrialised democracies to the G20 and its amalgam of both wealthy and emerging powers. The G20 encompasses 80% of the world's population and a similar proportion of global economic output, and in the eyes of the world it has greater political legitimacy than the G8 which barely accounts for 12% of the world's population. When thinking about global governance, the important measurement is the balance between the widest possible representation of global interests and the most effective way to implement policies. Too often, consensus means the lowest denominator and thus the least effective kind of action.

Rather than look to global institutions, an alternative is to employ regional institutions to act in the service of global governance. NATO and the European Union, perhaps the two most important multilateral institutions in the West, have proven value in preventing war and building prosperity. The test of their future worth will be how they adapt to the post-American world of the 21st century. Can NATO forge a new strategic concept that broadens the definition of security to include nation-building through effective police training and economic development? And can the European Union extend its mandate to help other regions of the world achieve peace and prosperity? Both institutions must adapt to the changing security demands of our time, and find new ways to work together on solutions that have proved so elusive in the past. □

Monica Frassoni
Co-President of the European Green Party

"The only global governance model that would work is federal"

The only model of global governance that would work in a world as complicated as this is federal; a system with a clear definition of (very) limited competences, a common charter of human and civil rights, an executive branch and a widely representative institution that we might compare to a global parliament. In this way, the few decisions taken would be recognised by all concerned and a genuinely global "public opinion" would be able to form and express itself, using all the new instruments of global communication.

Is this just a dream? Certainly, but it's also a political programme. Let's face facts; in the UN, the WTO and even in the EU, "governance" is still mostly done through intergovernmental negotiations that are tragically slow, obscure, disappointing, expensive, time consuming and all too often unfair in their results.

What we have to go for is a real global democracy. And we must do so by acting at different levels; the EU must resume its discussions on its future shape, the UN must reform itself and those wanting to go further on climate change or disarmament should create an ambitious "coalition of the willing" whose members would agree to give up part of their national sovereignty to find common solutions. Failing these steps, there will be no chance of global governance, but only the present global confusion. □

Angel Gurría
Secretary General of the Organisation for Economic Co-operation and Development (OECD)

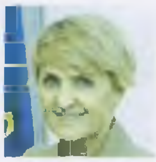
"G20 could give the momentum needed to usher in unprecedented international co-operation"

When Canada's Paul Martin and fellow finance ministers – including myself, as Mexico's then Minister of Finance – set up the G20 many years ago, we had the right vision. The rapid and far-reaching globalisation of markets has to find its counterpart in closer and more effective policy co-ordination.

Today's financial, economic and social crisis is confirming the truth of this, while the upgrading of the G20 to the level of heads of state and government testifies to the scale of the common challenge we face, and the need to build a stronger, cleaner and fairer world economy. International organisations like the OECD are ready to play a role in offering analysis and policy options, and in monitoring and ensuring follow-ups to G20 leaders' policy decisions.

The G20 accounts for 85% of global GDP, and 90% of global population, and has already given a convincing demonstration of its capacities for effective crisis management. Going forward, the world needs to be put on to a new growth path, and this requires leadership as well as competence, accountability and transparency.

The G20 framework for strong, sustainable and balanced growth could give the momentum needed to usher in a period of unprecedented international co-operation. Improved co-ordination on the economic, social and environmental fronts could do much to avoid future crises and underpin a more prosperous world economy. □



Danuta Hübner MEP

Chair of the European Parliament's Committee on Regional Development and former EU Commissioner for regional policy

"The dynamics of crisis have fundamentally altered the global financial system"

The dynamics of crisis have fundamentally altered the architecture of the global financial system, and have also changed our understanding of it. The facts have changed, and now our minds must follow. The upshot is that we are presently undergoing a fresh learning process as to the interaction of market participants and policymakers.

This "new normalcy" requires the development of a collective capacity to steer the global economy. Until the crisis broke, unbalanced patterns of demand in the global economy could have been resolved by co-ordinated efforts, but as we all know, these were sadly lacking.

The growing importance of the world's emerging economies is already shifting responsibilities for overseeing the global economy from the level of the G7/8 to G20 and perhaps G20-plus. But however many communities are eventually represented, groups such as today's G20 will have to stay committed to maintaining an open trading system.

The major challenge facing governments across the world will be the international harmonisation of rules and regulations. If national governments seek to resist the creation of a global rulebook for, say, financial services, banks and other financial institutions will shop across borders for the friendliest system.

On the fiscal side, however crucial co-ordination may be, it will be practically impossible to achieve. Tax benefits leak easily across frontiers, and the free-riding that results is difficult to police. Here we will have to cope with second-best responses.

We have already seen that the fastest channel to spreading the crisis around the world was the financial marketplace. And although we knew how to stabilise volatile capital flows, the available funding was nowhere near enough. The lesson we have still to learn is that no matter how stringent the new reforms are, they will not be effective unless we also back them up with adequate financial resources. □

Wolfgang Ischinger

Chairman of the Munich Security Conference

"We need fundamental reform of the international institutions"

With the change from G8 to G20, global governance has been given a new face. At long last, the forum of the world's biggest economies more fully represents all parts of the globe. But global governance is more than that.

In the first place, G20 decisions must be implemented coherently by all participating states. Second, global governance refers to all realms of international politics – economics, welfare and security – so international co-operation is even more essential where these policy areas overlap. Third, to be successful global governance requires a fundamental reform of the present international institutions, with the International Monetary Fund's voting rights an example of reform that is long overdue.

We will also have to discuss how to re-design the United Nations if we want to meet the most pressing challenges of the 21st century. And finally, global governance will always have an informal element; without private consultations beforehand, official decisions by institutionalised bodies will be difficult to reach. Fora like the Munich Security Conference can help to find common ground on how to meet these challenges, and contribute to enhancing conflict prevention and conflict management. □

Sandra Kalniete MEP
Former Latvian EU Commissioner for agriculture

"Global governance requires predictable and fair funding"

Because the major problems we all face are global, they can only be tackled by action at a global level. And this in turn requires a fundamental reform of the architecture of global governance. It's an enormous political challenge.

But change is already beginning to happen. Frameworks like the G20 and last December's Climate Change summit in Copenhagen underline the inadequacy of most of our present international institutions.

Among the ideas now being floated there is that of an "Age of Continents", in which it is sheer size that matters, so the world will in future either be run by a G2 made up of China and the U.S., or perhaps by a G3 that includes the EU.

The world's smaller states – and even bigger ones – are becoming increasingly irrelevant if they try to act alone without being active participants in regional integration and co-operative frameworks. Each EU member state – whether large or small – has to realise that its ability to be a global player depends on Europe's collective ability to govern the EU effectively and to make timely decisions. Pooling sovereignty is the only available alternative to global irrelevance.

Global governance also requires predictable and fair funding for tackling the most urgent global problems. The most obvious source of such funding is global taxation of carbon emissions and also of financial transactions. These taxes would not only help to fund development programmes but would also play a vital role in steering such policies as those needed to curb global warming and reduce harmful currency speculation. □

Sergei A. Karaganov
Dean of the School of International Economics and Foreign Affairs of the Research University – Higher School of Economics, Russia

"Despite its decline, Europe will be a shining example of how the world should be governed"

Several major trends will dominate the next two decades. There will be the continuous shift of economic and political power from Europe and to some extent from the U.S. to East and South Asia. But although Europe's geopolitical decline will continue, it will remain a beacon of stability and a shining example of how the world could and should be governed.

Russia, after reaching a peak of its new influence in 2007-2009, will also face geopolitical decline, moving in the direction of becoming a resource and food subsidiary of Great China, Inc., with a risk, too, of cultural decline. Key factors will be:

- The U.S. continues to drift away from Europe towards the Pacific.
- The greater Middle East region remains dangerously unstable.
- Nuclear weapons proliferation persists.

The combination of climate change, scarcity of pure water increase of demand for food, energy and mineral resources is set to create a new global agenda, including competition for territory. So what model of governance for this kind of a world would be feasible, even if hard to envisage today? In the field of economics and finance – a G2 of the U.S. and China leading the G20, or possibly a G3 that included the EU that would also lead the fight against climate change.

In the field of hard and nuclear security – an alliance-type relationship between the U.S. and Russia, moving towards a triangular relationship with China. And for "semi-hard" security – stability – a new euro-atlantic security alliance, or Russia in NATO, thus finishing the "unfinished Cold war". And a "Union of Europe" between Russia and the EU, with common human, economic and energy spaces – the only hope to prevent the further marginalisation of both while providing a third stabilising pillar for the future international order.

There should also be a new collective security arrangement for the larger Persian Gulf area, with nuclear guarantees provided to all countries of the region by the great outside nuclear powers. And the UN should stay, of course, with an enlarged Security Council and be a provider of common rules and a universal panel for debate. □

Kishore Mahbubani
Dean of Lee Kuan Yew School of Public Policy, National University of Singapore

"Europe provides both the problem and the solution to reforming global governance"

We are entering a new era marked by the end of western domination of world history and by the return of Asia. All global institutions and processes will have to be reformed to accommodate this new era, but this will not be easy.

The West, especially Europe, is heavily over-represented globally. Europe makes up 12% of the world's population, yet it has 40% of the permanent seats in the UN Security Council. The EU is also over-represented in IMF voting shares. The Benelux countries have a greater voting share (4.57%) than China (3.66%). Not surprisingly, European interest in preserving over-representation has become a key obstacle to reforming global institutions.

Paradoxically, though, the EU's success in promoting genuine regional harmony and co-operation within Europe provides the best possible role model for reforming global governance.

Such EU principles as avoiding military conflict, greater trade and economic integration, fair and equitable representation in key decisionmaking bodies and accountability for governance decisions are the same principles that will be needed to reform global governance. Europe provides both the problem and the solution to reforming global governance. □

Reza Moghadam
Director of the International Monetary Fund's Strategy, Policy and Review department

"We at the IMF have already begun the process of reconciling effectiveness and legitimacy"

As we begin to emerge from the current crisis, the great unknown is whether the spirit of global co-operation and co-ordination that staved-off collapse will survive to lay the foundations of a sustainable recovery.

Fortunately there are encouraging signs, the most important being the emergence of the G20 as a very successful forum for economic and financial dialogue and co-ordination. To their credit, the G20 countries are looking ahead and committing to drawing periodically on IMF analysis to assess the consistency of their policies. Whether the G20 members will be able to achieve sufficient policy collaboration and action remains to be seen, but the act of committing to a process is a crucial step forward.

The G20 is nevertheless still an exclusive group in which some 165 countries are not represented. This means that at some point effectiveness and legitimacy will need to be reconciled. At the IMF – which is itself struggling with these issues – this process has already begun, with major quota realignments and more transparent management selection procedures now at the top of the governance agenda.

If these efforts succeed, we will face the interesting prospect of thinking about completing the transition in global governance from the G7 to the G20 to the G186. □

Jean Pisani-Ferry
Director of BRUEGEL, the Brussels-based economic think tank

"After a brilliant start, global co-operation and governance may disappoint in the years ahead"

The G20 summits of 2008-2009 helped resist the temptations of protectionism and delivered a global agenda on new financial regulation, concerted stimulus efforts, a major increase in the IMF's resources and an unprecedented commitment to macroeconomic co-ordination.

It wasn't a negligible harvest, so now the question must be whether this co-operative spirit can last long enough to survive the acute phase of the crisis? For the aftermath may be less easy to deal with than the apex, with two issues of particular relevance. The first is the future of the co-ordination process launched last year at Pittsburgh, whose goal is a rebalancing of global growth. How can a heterogeneous group of countries succeed, when some – not least the U.S. and China – have no tradition of allowing foreign oversight of their domestic policy choices?

External surpluses and deficits and corresponding exchange rate policies will be key, as any re-balancing of global economic growth requires the U.S. and China to engage in major overhauls of their own growth models. Domestic adjustment has started on the U.S. side, but it's by no means certain that the U.S. political process will take external dimensions into account when confronted by the hard choices that lie ahead. And welcome as it was, China's stimulus shouldn't be seen as a first step towards more consumer-oriented growth.

The task ahead for Chinese policymakers is daunting, and China's refusal to bow to U.S. and European pressures on revaluing the renminbi doesn't bode well for future macroeconomic and monetary co-operation in the G20.

The second issue is the redefining of global governance responsibilities. Europe's huge over-representation in international organisations like the IMF and World Bank has long irritated the rest of the world, and so far, the G20 has achieved no progress on this. An even more difficult question is whether the emerging world is ready to take part fully in the fashioning of new global rules. Again, China's answer will be key; for all the talk of G2, Beijing still seems very reluctant to take on its full share of global responsibilities. It will still be a poor country when it overtakes the U.S. as the world's leading economic power, and right now it lacks the human resources to play a full role in international financial diplomacy. China is also afraid of being made co-responsible for decisions it will have little ability to influence.

The upshot of all this is that after a brilliant start, global co-operation and governance may disappoint in the years ahead, even though it is to be hoped that the acquis of 2008-2009 will provide the basis for its further development. □

Hans-Gert Pöttering MEP
Former President of the European Parliament

"The European Parliament must play a central role if we want a democratic model of global governance"

In the context of ongoing globalisation, global governance is surely needed to provide solutions for key political problems that are more and more exceeding their longstanding geographical limits. The focus of political decisionmakers cannot stop at a border when our problems are so international.

The best example of these new challenges is, of course, the fight against climate change. Saving our environment is by its very nature a global question, and there is no doubt that only global agreements can counter the ecological dangers we have ourselves created.

This makes it a prime example for the problems of modern global governance. Interest groups and multinational corporations are competing for the attention of policymakers, and at the same time new ways are needed to ensure that citizens' voices are heard loud and clear.

The European Parliament as a directly elected body that is the only supranational parliament in the world, must play a central role if we want a democratic model of global governance. □

Jiang Shixue
Deputy Director of the Chinese Academy of Social Sciences' Institute of European Studies

"China would never accept the idea of a G2"

With the emergence of so many global issues, strengthening global governance has become not just important but very necessary. To make it effective, we need to keep a number of principles in mind: First, global governance should be implemented in the framework of a multi-polar world order. This means that the idea of a so-called G2 alliance between the United States and China is totally nonsense. China would never accept such a notion.

Second, global governance should never be used as a pretext to intervene in any nation's internal affairs and sovereignty. In other words, it needs to be accompanied by co-operation, participation and mutual respect between nations.

And third, as part of the process of strengthening global governance, the interests of the developing countries must be protected. In particular, the emerging economies, such as the BRICs (Brazil, Russia, India and China), must be given a major say in designing the rules that will relate to global governance.

And last but not the least, the United Nations must be given an important role in any future global governance arrangements. □

Danilo Türk

President of the Republic of Slovenia

"We need global institutions capable of making international co-operation inclusive"

There is scarcely any more pressing a question then that of seeking a new model of global governance. The world needs an alignment of its major economic and military powers to ensure global order and peace.

At the same time, the world needs global institutions capable of making international co-operation inclusive, participatory and sustainable. Today's polycentric world offers us a real chance of achieving the former, but reform of our existing global institutions is going to be needed if we're to get the latter.

The lynchpin of the two is the emerging G20. It is hard to say whether that group can move the world in the right direction, but there will be an early test; reform of the International Monetary Fund. Let us press for global financial reform that would include as an early measure IMF reform and real changes to its quota system, its decisionmaking process and its lending policies. □

Guy Verhofstadt MEP

Leader of the Liberal Group in the European Parliament and former Belgian Prime Minister

"Integration that transcends borders is the logical response to 21st century realities"

There is in this day and age no single state big or rich enough to meet the global challenges. The internationalisation of our economies and financial systems along with climate change and terrorism have increasingly made policy measures by nation states inappropriate and irrelevant.

National governments are choosing more and more to join together in regional co-operation structures to tackle common problems. Unlike the great empires of the past, these regional blocs are meant to create a functioning politico-economic equilibrium based on consensus and common purpose.

If we are to adjust global governance accordingly, these regional powerhouses need to be represented in the UN Security Council and at the IMF, the World Bank and the WTO. Only in this way will we build a global system that is prepared to take decisive action on the political, economic, financial, commercial and environmental challenges facing our planet.

Integration that transcends the borders of the old nation states is the logical response to 21st century realities. This will lead us to a safer, more democratic and more prosperous world in the 21st century. □

Worldwide reform means engaging public opinion first

There are real fears that the deep-seated reforms demanded by the global financial and economic crisis will not get the public support that is needed, warns former Polish finance minister Leszek Balcerowicz. He sets out a six-point approach to long-term recovery

Crises such as the present one seriously disrupt our economic growth, but the question we should also be asking is in what ways do they affect longer-term development? It's an important question, yet it has attracted surprisingly little research.

Traditional growth theories focus on systematic growth forces which by definition operate all the time, although with varying degrees of intensity. These forces consist, among others, of capital accumulation, employment and technical change. And going deeper, there are underlying institutional factors like property rights, market competition, tax and regulatory burdens and the effectiveness of the rule of law.

Integrating different streams of analysis into a new and coherent approach to economic growth is a huge challenge to policymakers

Another strand of economic research focuses on the causes of the financial and economic crises, but without looking at them in a longer-term growth perspective. And yet another one deals with crisis management, meaning what governments should do once a crisis erupts. In the case of a financial crisis this usually includes fiscal and monetary easing as well as rescue operations for larger financial institutions. The prevailing approach to crisis management has been short-term, and as was amply demonstrated during this latest crisis, was based on what I would call, perhaps rather pointedly, the self-justifying doctrine of intervention.

This holds that whatever crisis management measures are adopted, they are invariably justified by the argument that the alternatives would have been worse and might well have provoked catastrophe or even a meltdown of financial markets. Metaphors like 'if there is a fire, you don't worry about pouring on too much water' have been deployed to support this approach, even though they remove from the analysis such elementary questions as how to measure what are optimal doses of anti-crisis medicine that won't weaken the forces of market recovery, while also assessing the longer-term legacies of their crisis management measures.

This latter problem has only recently begun to surface in the debate under the heading of governments' "exit" strategies from sharply increased levels of public debt, from sharp increases in central banks' money supply levels and from the increasingly widespread belief that large financial institutions will go on being "too big to fail". Integrating these different streams of analysis into a new and coherent approach to economic growth is a huge challenge to policymakers and academics alike. But a number of points strike me as relevant to the current situation.

First, because financial crises as deep as the present one are socially so costly, it is only natural to try to prevent them. But just as with medicine, this demands an accurate diagnosis of a problem's causes. The proximate reason for all financial crises is the excessive growth of credit – a credit boom which goes bust. But the underlying reasons for the boom differ from crisis to crisis. In the present case, as the De Larosière report emphasised, a major contributory factor was the serious failure of public policies; the U.S. Federal Reserve's excessively loose monetary policy was followed by many other central banks, while other factors included defective financial regulations, expansionary fiscal policies in countries like the U.S., Britain and Ireland which suffered serious

COMMENTARY

By Adam S. Posen

We can argue about the causes of the crisis, but agree on its lessons

Leszek Balcerowicz is absolutely right that we must seize on the current crisis as an opportunity for reform. He is also right that the policy response to the crisis, though necessary, must not be allowed to lastingly set back growth and progress in Europe. Finally, I fully support that the reform efforts must be linked to a public understanding of the causes of the crisis. Unfortunately, the specific causes and measures he advocates falsely interpret those causes, and the situation in Europe that has come out of the crisis.

First, on causes Balcerowicz's emphasis on monetary and fiscal laxity is misplaced. The crisis was largely due to the excessive laxity of bank supervision and regulatory enforcement in the financial sector. The idea that it was macroeconomic policy that caused the crisis doesn't fit the facts – many countries that had bubbles, including the UK, had much higher interest rates and much tighter public budgets than the U.S., and many countries that didn't have bubbles were exposed to large capital flows and global low interest rates (if the latter is what matters). The timing is also wrong, with the Federal Reserve's supposed excessive ease coming into play well after the bubble was underway. Those countries that did a better job of regulating and supervising their financial systems suffered less damage.

housing bubbles, a lack of appropriate macro-prudential regulations, and so on. Preventive measures should therefore focus on these policy failures rather than degenerating into hostility towards hedge funds and other private equity devices.

My second point is that there are a number of obvious economic channels through which booms that turn into busts will affect growth. These include increased unemployment, the reduction of excessive debt burdens and therefore of credit-driven spending, the restructuring of those sectors that had expanded in response to excessive spending, and the curtailment of lending by previously over-extended financial institutions.

There exist no policies that could suspend the operation of all these linkages without damaging longer-term growth. Continued fiscal expansion is certainly not the answer, as after a while it damages both private spending and business investment. But there are reforms that can facilitate the adjustment of the economy, and thus ease social pain by countering the growth in long-term unemployment. These reforms include measures to remove the labour market rigidities while also speeding-up the repair of banks' balance sheets. The speed with which economic recovery can be achieved would largely reflect the extent to which these steps are taken.

Third, and on a closely related note, most if not all EU countries were already in need of substantial structural reforms long before the crisis broke. This was due to a combination of their fiscal problems, their lack of competitiveness and the aging of their societies. Today's crisis makes these reforms more imperative than ever.

My fourth point, other than for those who still believe in a free lunch, is that the employment and growth implications of the EU's commitments in the area of climate change policy need to be carefully analysed. Multiplying the number of burdens being placed on the European economy is not the best policy to be implementing in the aftermath of a crisis of the scale we now face.

Fifth, it is difficult to overestimate the importance of fiscal discipline on longer-term growth. It is all too easy to find examples of countries that subsequently suffered badly because of sustained expansionary fiscal policies. By the same token, I cannot think of a single case when the long-term growth prospects were damaged by excessive fiscal stinginess. Given the fiscal legacy of the current crisis, no efforts should be spared in anchoring fiscal discipline firmly in the EU countries. Institutional measures such as a fiscal frameworks and public debt thresholds can do much to help. Ultimately, though, it is public opinion that will determine governments' fiscal stances, so fiscally conservative public opinion would be a great economic asset as it would constrain policymakers' profligacy. It is therefore up to opinion leaders to strengthen this sort of attitude.

My last point is that crises are of course unpleasant, but they are also widely thought

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Second, and reflecting this reality, the real challenge is to unwind the emergency guarantees and state interventions into the financial system, while restoring the necessary degree of regulatory discipline. This will take a true buy-in from the public now that the moral hazard of governments bailing-out both too-big-to-fail institutions and too-widespread-to-lose forms of savings has become the expectation. Fiscal and monetary discipline, on the other hand, will for the most part be restored shortly, although with some pain and protest. But the recognition of bond market requirements, even if not of strict adherence to the Maastricht fiscal criteria, is binding throughout Europe – and with one notable exception, was problematic before the crisis, long-term interest rates and inflation expectations in European economies reflect this reality.

Third, the vast majority of economies in the eurozone and in eastern Europe are right to treat the crisis as an exogenous demand shock – something that is coming from outside their control, and is temporary. Whether in the form of Finnish and German programmes to support work-sharing or the Czech Republic and Poland's tolerance of one-time currency depreciations without changing monetary policy frameworks, those economies that are without structural imbalances are right to ease temporarily in response to a demand shock. The minority of European countries that need more fundamental rebalancing, such as Ireland, Hungary, and Spain, obviously face a different set of challenges.

We would be wrong on the politics as well as the economics, however, if we did not publicly recognise that the majority of European

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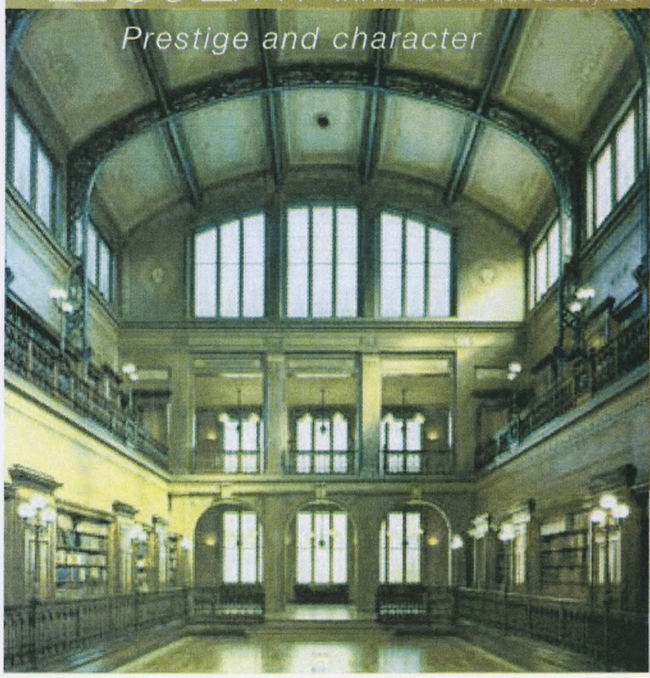

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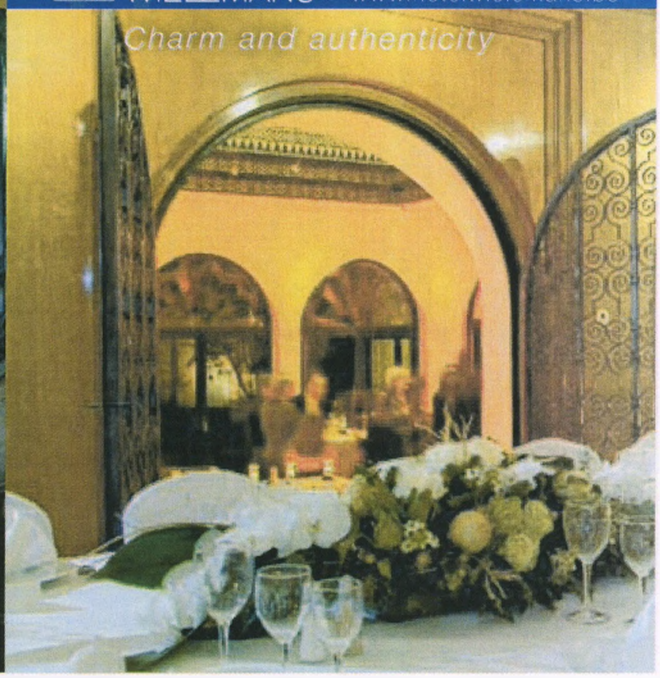

to facilitate growth-enhancing reforms. This isn't always the case, though, as the policy conclusions that will be drawn from the present crisis will largely depend on what the public perceives as the reasons that caused the trouble. If European public opinion were to put the blame on previous market reforms, the policy lessons to be drawn from the crisis may go off in the wrong direction. This was precisely the case in Russia in 1998 and in Argentina in 2000, as in both cases the dominant stream of public opinion blamed previous reforms for the crisis even though the truth was that both crises had been caused by fiscal irresponsibility and insufficient reform.

Having said that, if public opinion across Europe holds policy errors or the lack of reform as responsible for the crisis, then there is a chance that the right policy lessons will be learned and that sound growth policies will result. The key to overcoming the crisis and its difficult legacy is the way that Europe's citizens perceive the origins of the financial crisis that erupted in the autumn of 2008. □

Leszek Balcerowicz is a former Deputy Prime Minister and Finance Minister of Poland (1989-1991; 1997-2000) and a former President of the National Bank of Poland (2001-2007). lbalce@sgh.waw.pl

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states in terms both of population and economic weight responded rightly to the crisis, and did not cause it. The one-size-fits-all re-statement of the same old list of neo-liberal critiques of pre-crisis Europe, which the Balcerowicz article appears to support, is misguided in the current context. Yes, the Kurzarbeit-type measures could, if allowed to persist, impede labor re-allocation in normal times, and a reliance on devaluations is a long-run loser. And yes, there certainly still are structural concerns about Europe's low trend productivity growth, made the more pressing by the demographic burden. Yet most of Europe had made great strides on labour market liberalisations before the crisis, and dogmatic financial liberalisation has proven to be excessive. There certainly is room to re-think the recommendations. □

Adam S. Posen is a Senior Fellow at the Peterson Institute for International Economics, and an external member of the Bank of England's Monetary Policy Committee. aposen@piie.com.

Why U.S.-EU economic co-operation holds the key to global governance

The globalised economy and the rise of new economic giants demand a radically reformed international system, says Robert Hutchings. But it will nevertheless fall to Europe and America to fashion these new structures for global governance

Despite the many calls for a "new Atlanticism" or a "new transatlantic bargain," the U.S.-European relationship is still imprisoned by old habits and ways of doing business. Yet, it is an inescapable reality that almost all the new challenges lie outside the traditional NATO relationship, and many of them are in areas where U.S. and European views have long diverged.

It would be too much to ask that there be a U.S.-European meeting of the minds on every global issue, but on many of these issues U.S.-European strategic convergence seems both possible and necessary. These include management of the global financial and trading system, addressing energy security and climate change, and re-fashioning existing international institutions to address all these problems.

Perhaps it has taken the global economic crisis to compel Americans and Europeans to revitalise their co-operation and exercise co-leadership. It was noteworthy that the International Monetary Fund found itself totally sidelined, making it the first time since its creation at the 1944 Bretton Woods conference that it has played no role in a major financial crisis. It was for this reason that the Europeans, led by UK Prime Minister Gordon Brown, called for a summit meeting of the G20 world economic powers to consider a "Bretton Woods II" world financial architecture, bypassing not only the IMF but the G7 as well.

This initiative and the three G20 summits which have since taken place – Washington in November 2008; London in April of last year; and Pittsburgh in October – have been a promising start. With European and U.S. leadership, several measures were undertaken to strengthen financial oversight and monitoring via the IMF and a Financial Stability Board that replaces the old Financial Stability Forum. The G20 leaders also agreed to recapitalise the IMF and multilateral development banks via an impressive $1.1 trillion package of measures to assist the poorest countries. The G20 was formally designated at Pittsburg as the premier forum for international economic co-operation, but although it is far more inclusive and representative than the G7, the G20 is itself far from ideal because Europe is so greatly over-represented,with France, Germany, Italy, the UK and the EU all having seats at the G20 table.

The essential next step is to bring the new economic powers more fully into the global system and to have their growing power and influence reflected in the IMF, World Bank and other institutions. The emerging market economies account for 30% of global GDP, 45% of total exports, and 75% of foreign exchange reserves, yet the traditional Western powers of the OECD continue to hold 63.8% of the total voting shares in the IMF, with the G7 alone constituting 43.7% of the total.

One possible formula would be for the U.S. to relinquish its sole veto in return for the EU to reduce its voting share at the IMF from 30% to the same as the U.S.

Symbolically, a good place to start would be for the United States and Europe to give up their conventional claims to the top World Bank and IMF jobs and open those leadership positions to candidates from other countries. Procedurally, emerging economic giants like China and India should be accorded substantially greater voting power. One possible formula would be for the U.S. to relinquish its position as the sole country with veto power in return for the EU's agreement to reduce its combined voting share at th IMF from 30% down to the same level as the U.S. The size of the IMF's executive board should be reduced from 24 to 20 by consolidating European representation. Although the United States and its European partners have pledged to reform IMF governance, so far they have been loath to relinquish their privileged positions.

The global financial crisis also has contributed to a growing crisis of the world trading system, with governments responding to anti-globalisation pressures by pursuing mercantilist policies. Bi-lateral and regional trade agreements have been proliferating, most of them the kinds of discriminatory trade deals that the U.S.-led international order was designed to prevent. Meanwhile, the Doha Development Round, launched in the aftermath of 9/11, risks becoming the first post-war multilateral trade negotiation to fail. Doha's failure would aggravate protectionist pressures and could cause irreparable damage to the World Trade Organisation's own credibility.

Yet despite their rhetorical commitments to completing the Doha round, neither the U.S. nor any other economic power has done much to move it forward, and the reasons for this inaction are not hard to find. In the U.S. and elsewhere, it has sparked widespread opposition from workers and trade unions, and only tepid support from the wider public. It is, in short, the familiar story of gains being widely distributed while losses are sharply focused, usually by sector, often by region. Reviving Doha will only be possible if the American public and the Congress see large, headline-grabbing benefits that could offset opposition from those who would be adversely affected. The abstract appeal of free trade would need to be accompanied by a widely shared conviction that it is fair as well as free.

A bold international move would be needed to overcome entrenched positions, and that means a deal involving substantial concessions by the U.S. and the EU on agriculture in return for commensurate commitments by India, Brazil, China and others to open their own markets for services and agriculture. With the Europeans, simultaneous pursuit of an "enhanced transatlantic market" would make a new U.S.-EU Doha initiative on agriculture more attractive to both sides, as it would aim at reducing additional barriers to transatlantic trade that are not covered in the multilateral round.

On energy and environmental co-operation, the G20 has increasingly taken on a key role that reflects the fact that its members account for more than 85% of global economic activity, energy consumption and greenhouse gas emissions. As in global finance and trade, solutions to the world's growing energy and environmental challenges call for new mechanisms and the greater involvement of China, India and other rising powers.

Another legacy of the outmoded international system is that the International Energy Agency includes none of the major energy supply countries. The U.S. and Europe should take the lead in expanding its membership to include China, India, Russia and other non-OECD countries, and in elevating the IEA, along with an expanded Energy Charter Treaty, as a forum for energy security through negotiation among suppliers, consumers, and transit countries.

The EU and U.S. should also exercise leadership in fashioning a new global environmental regime that includes the world's rising economic powers. As Copenhagen's outcome has made clear, a global mega-deal is probably not feasible under current economic conditions, so the most realistic outcome would seem to be flexible national plans with political, rather than legally binding, commitments to cap carbon emissions by 2050, reviewed and monitored by an international body analogous to the WTO trade policy review mechanism. To induce China and India to join such a consensus, the U.S., EU and Japan would need to take the lead in assembling a clean energy fund with significant private sector participation – a more ambitious version of the International Partnership for Energy Efficiency Co-operation (IPEEC) established at the G8 summit in L'Aquila, Italy, last July.

In sum, the world is on the cusp of the most profound shift in global power and influence in a century. Managing this quiet revolution calls for nothing short of a new international system, with a radical revision of existing institutions and patterns of doing business. The existing international system, fashioned for the world of the mid-20th century, is not very relevant to the new global agenda, and the emerging re-distribution of power roughly from west to east is unlikely to permit any new global order to be managed by a U.S.-European condominium.

Having said that, the United States and Europe nonetheless have an indispensable role to play in fashioning a new global order that can integrate the rising powers and accommodate their interests, while at the same time preserving the basic liberal values that have underpinned the western-led post WWII system. But an attempt to deal with new problems within the framework of existing institutions cannot provide the solutions required. This is where the international community has been stuck for nearly two decades since the end of the Cold war; trying to adapt those institutions to new challenges and open them to new members, while invoking a sense of common interests that were more relevant to the last half of the 20th century than they are to the early 21st. That effort at incremental adaptation has almost run its course; now a new burst of creativity and leadership is needed.

It has been a popular rallying cry since the end of the Cold war that on almost every issue of the day Americans and Europeans would be better off working together than working separately. It is an inspiring message, and may even be true, but the years since the collapse of the old order have shown that just because Americans and Europeans should act together in this new era did not necessarily mean they would do so. □

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Ending boom and bust: The case for macroprudential instruments

What can be done to make the world's financial markets more resilient and the 'real economy' more stable? **Paul Tucker**, Deputy Governor of the Bank of England, sets out his thinking on why new macroprudential policies are needed

There is a widespread agreement that we must all do our utmost to avoid a financial crisis like this again. And to do so we need a more resilient financial system that will be less prone to boom and bust. Part of the solution lies in the regimes that restrain the behaviour of banks and dealers so that they can withstand adversity. But another part lies in whether the authorities can lean against the boom phase of the credit cycle.

That's why in late November the Bank of England published a discussion paper on the possible role of macroprudential policy in helping to restrain the future build-up of risks within the financial system, and the threat these can pose to the economy generally. The aim would be to make the financial system more resilient and the real economy therefore more stable. With its focus on systemic risk, macroprudential policy sits between pure macroeconomic policy and the micro regulation of individual financial institutions. Along with regulators, central banks have a clear interest in helping to develop ideas in this area, not least to avoid an unrealistic burden being placed on monetary policy. The recent crisis has reminded everyone that the business cycle and the credit cycle are not always the same.

The key elements of this debate can be put under the following headings: policy aims and objectives; policy instruments; whether to deploy those instruments on the basis of rules or by using discretionary judgment; and international co-operation. Behind its technical detail, there lies the straightforward question of whether our economies can create regimes in which the authorities are ready and able, as the Federal Reserve's Chairman William McChesney Martin put it some 50 years ago, "to take away the punchbowl when the party threatens to get out of control." Having a body that meets regularly to consider precisely that issue might serve us well because it would mean that during the good times at least one body remains focused on how the good times might go sour. But that sort of body is feasible only if we can design the instruments and mechanisms needed to hold to account the relevant authorities.

To begin with the aims and objectives, in big picture terms these include quelling asset price booms, targeting credit growth and strengthening the resilience and performance of the banking system during credit booms and busts. The Bank of England discussion paper aired the possibility of focusing on the resilience of the banking system over the credit cycle because that would indirectly affect credit supply conditions and so help to lean against credit-fuelled booms.

So why not target asset prices? Essentially because we at the Bank of England feel that the threat to financial stability is greatest when exuberance in asset markets is accompanied by excess credit growth and indebtedness. It is the impact of falling asset prices on an over-leveraged and liquidity stretched financial system that imperils the provision of essential financial services to both businesses and households. But, in that case, why not cast the objective solely in terms of targets for credit growth? We doubt it would be feasible. Macroprudential instruments could be deployed to influence the terms on which credit is supplied by the banking sector, but the resulting growth of credit will also depend on demand conditions which lie beyond the direct reach of macroprudential instruments. Also, residents of industrialised countries are free to borrow abroad, so total credit growth

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By Lars Nyberg

Cross-border banking is the problem, and also the solution

The most striking feature of the crisis is its international dimension. Earlier financial crises have mainly been national, and so were of national concern. But globalisation and the development of large cross-border financial institutions have changed all that, so problems arising in one corner of the world spread rapidly to others.

The heart of the matter is the mismatch between responsibilities and powers. The responsibility to clean up the mess in a national financial system that was caused by the failure of a cross-border institution may well lie in one country, while the main powers to regulate and supervise it rest with another. Needless to say, the incentive structure for the banks and other financial players is unsettling because so many mixed signals are likely to be sent.

This could lead a government to one of two conclusions. One would be essentially to close its borders to financial services and take a protectionist stance on regulation, supervision and crisis management. Protagonists of this view have a fully justified fear of having to pay for problems caused by some institution or market over which they have no control. But this would nevertheless be a costly and reactionary road to follow, as well as a tremendous blow to European integration that carries cannot be controlled by constraining domestic lenders. But there is no good reason to turn our backs on the free flow of capital across borders, so we need a macroprudential regime that caters for that.

Focusing on the dynamic resilience of the domestic banking sector' would be likely to act to some degree as a circuit-breaker on domestic credit supply. So there would be an effect on credit conditions, and so plausibly some indirect taming of the credit cycle during the upswing. And, crucially, during the subsequent downswing, the macroprudential dial could be relaxed where necessary to lean against the risks of a perverse downward spiral in the supply of credit, the economy and the strength of the banking system.

To make the financial system more resilient and the real economy therefore more stable, macroprudential policy sits between pure macroeconomic policy and the micro regulation of individual financial institutions

Turning to policy instruments, the obvious ones are capital and liquidity requirements for banks, and how much collateral they must take when lending to borrowers on a secured basis (often known as 'haircuts'). Let's take by way of illustration just one approach; that of applying a top-up or 'surcharge' over and above the usual regulatory minimum capital requirement. Those surcharges could be applied to headline capital requirements or at a more disaggregated level, through 'risk weights' on different classes of lending and exposure. To lean against accumulating risks to stability, they would need to vary counter-cyclically, increasing in a credit boom and perhaps falling during a cyclical contraction in the supply of credit.

The case for focusing on particular classes of lending is as follows; imagine that the authorities judge that a boom in lending to a particular sector of the economy had become overly exuberant and so threatens stability. Assume that this lending was to the shadow banking system (say conduits, special investment vehicles and so on). If the authorities were to raise the headline minimum capital ratio, banks could respond in a number of ways, including the perverse reaction of cutting lending to parts of the real economy that were showing no signs of exuberance, while continuing to lend on overly relaxed terms to the exuberant shadow banking system. In the real world this might well happen if lending of this sort seemed to offer terrific returns. A regime like that would not command support for long. Of course, the focus should sometimes be aggregate credit conditions, but if the relevant authority were always to delay its intervention until everything was booming, it might be harder to restore calm to the party.

To turn to the key question of whether clear-cut rules or the discretionary judgement of the authorities should determine the use of policy instruments, it's worth saying that many commentators would ideally like policymakers to use simple rules. This helps people to understand what is going on, and makes it easier to hold policymakers to account. But accountability for a flawed rule helps nobody very much, and we at the Bank of England are doubtful that such a thing as a simple rule either exists or could be developed. If that view is correct, then judgment would always be needed to make reasonable policy choices. That in turn would call for an assessment of the resilience of the system, credit conditions, sectoral indebtedness and systemic spillovers. In short, all the available evidence would need to be weighed.

In very broad terms, this would be akin to applying Basel-Capital-Accord Pillar II-type judgments to banks in general. Doing so would share with the Pillar II element of micro prudential regulation a focus on the circumstances that warranted a capital charge different from the Pillar I minimum. But it would also differ in a number of important respects; first, any changes would have to be applied to all banks in the authorities' jurisdiction, with individual banks being affected differently depending on their exposure to risk. Second, raising of capital requirements would depend on the problems facing the whole system, including how badly banks were exposed to each others' risks. Third, although in the micro prudential setting Pillar II always adds to the Pillar I minimum, a macroprudential authority might actually reduce risk weights and therefore capital requirements during a credit cycle's downswing. Fourth, application of a capital charge would need macroeconomic as well as financial system inputs, so to the extent that top-down stress tests were employed as one of these inputs, there could not be a standard battery of mechanical scenarios. They would need to be tailored to the risks confronting the financial system and the economy as a whole.

It would be important to constrain such a macroprudential regime so as to ensure

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with it the loss of future welfare gains for the EU as a whole.

A different and more promising avenue from a European perspective would be to move in the opposite direction by further enhancing cross-border co-operation. This will admittedly be challenging as one would need to find new ways of managing national interest conflicts that arise in cross-border crises, meaning better burden-sharing mechanisms. It's never going to be easy, but discussing these matters ahead of a crisis rather than during it would greatly improve the chances of success.

Inevitably, globalisation and cross-border integration will also increase the role for supranational solutions. The development of European supervisory agencies and of a European Systemic Risk Board are important steps towards creating the sort of framework that can effectively oversee an integrated EU financial services sector.

The failure of financial regulation and supervision has been a painful feature of the crisis, for the existing frameworks were demonstrably ill-equipped to curb exaggerated risk taking in upturns and, conversely, destructive herd behaviour in downturns, or to contain the rapid spread of problems throughout the financial system. Extensive efforts are now being made to design a regulatory and supervisory framework that will reduce the risks of a major new financial crisis. As Paul Tucker puts it: "...putting in place a workable framework for macroprudential policy is now one of the great challenges facing our generation". I couldn't agree more.

transparency, accountability and a degree of predictability. That in turn would call for a very clear timetable for taking decisions, and for public explanations of those policy decisions. Even if the relevant authority had not actually used its policy instruments, a public explanation of the areas of banking it had examined might help to focus the minds of banks' managements and the boards of directors.

What of the international dimension? There are big questions about whether a country could do any of this on its own, and whether tight co-ordination would be both needed and would be effective enough.

A useful illustration might be a case where the financial stability authorities in one country increased the risk weight on, say, domestic mortgage lending. The measure would apply only to banks headquartered domestically or operating out of a subsidiary, but could not apply to branches of foreign headquartered banks, still less to purely cross-border activity. It is easy to imagine that, rather than borrowing from domestically-domiciled banks, mortgage brokers would arrange for households to borrow from a lender based abroad, or at least with the loan booked abroad. In terms of the accumulation of debt in the sector concerned – in this hypothetical case, households – there might be little or no effect. That would obviously not be great for the risk of default by the borrowing sector concerned, but domestically based banks would have been required to build their defences. If so, the damage to those domestic-based banks of any financial strain would be reduced, and the eventual economic costs might be lower, especially if they were able to take up some of the slack created by withdrawal of credit supply by foreign banks to sound borrowers.

One might even go further than that. In the first place, a domestic authority increasing capital or liquidity requirements on lending by its banks to a particular sector could act as a signal to international counterparts like to the home authorities of overseas banks. It would clearly be important to share this sort of analysis with peer organisations elsewhere, even if things went no further than that.

More market transparency would of course strengthen that international dialogue and might usefully form part of a wider discussion on the use of macroprudential instruments. For putting in place a workable framework for macroprudential policy is now one of the great challenges facing our generation, and an active exchange of ideas is needed. The thoughts set out here draw on existing work by other regulators and central banks, but a lot more work is needed before policies of this sort could be put into practice. There are plenty of other elements to such a regime, but at least a debate is now under way. □

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At the same time, we all realise that it would be futile to think that we can rule out future crises in the financial system. One of the most important lessons of this crisis is the importance of effective crisis management.

When a crisis breaks out, it is important that the rules of the game should be as clear as possible, so if we are to minimise the risk of future crises we need a system in which banks' shareholders and creditors know they must not expect any government bail-outs. □

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