# lakyara

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## Whither the G7?

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As the center of gravity for economic growth shifts, the forum for deciding the “rules” governing the global economy is moving from the G7 to the G20. Exchange rate policy is an important domestic economic policy as well as a means of adjusting the current account imbalances in the long run. Inasmuch as it plays a larger role in emerging economies, I disagree with the idea that the G7 should specialize in the coordination of exchange rate policy. But to the extent that G7 nations have a large advantage in the global financial system in terms of transactions, business presence, and capacity for regulation, the G7 could be utilized as a forum for coordinating financial regulation.

## Introduction

Decisions regarding the global economy are increasingly discussed at G20 meetings, which include representatives of the emerging economies, rather than at the G7. In addition, the G2 of the US and China is said to take the lead as China makes rapid advances on political and economic fronts. Such decline in the G7's role has elicited sentimental reactions in Japan. The G7 left an impression among my generation as the stage for the decision in 1985 to pursue a major adjustment in USD/JPY rate. And for those in an older generation, gaining membership in the G7 was an emotional symbol of Japan's return to club of industrialized nations following its defeat in the world war.

In the past, later March was a time when market participants in Japan and elsewhere focused on speculation about the upcoming G7 meeting. In memory of this tradition, I would like to use this report to consider the future of the G7.

## Center of gravity shifts to G20

While the developed nations continue to suffer from the financial crisis and the subsequent recession, the emerging economies have recovered quickly from the negative impact of the plunge in exports and have posted strong, sustained rebounds. They are expected to continue to outperform the industrialized economies owing to structural factors (such as a rapidly growing middle class) and accommodative economic policies (Exhibit 1). Inasmuch as the developed nations will have to rely on export demand from these economies to sustain recoveries, they need to respect the presence and views of the emerging economies and have therefore been forced to pay more attention to the G20.

Exhibit 1. Outlook of economic growth (WEO : y-on-y %)

| | | | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|
| World | | | -0.8 | 3.9 | 4.3 |
| | Developed Economies | | -3.2 | 2.1 | 2.4 |
| | | (US) | -2.5 | 2.7 | 2.4 |
| | | (EU) | -3.9 | 1.0 | 1.6 |
| | | (Japan) | -5.3 | 1.7 | 2.2 |
| | Emerging Economies | | 2.1 | 6.0 | 6.3 |
| | | (Asia) | 6.5 | 8.4 | 8.4 |

Source: IMF

In the industrialized nations, measures taken in response to the crisis and subsequent economic packages have pushed fiscal deficits higher, while little has been done to reduce those deficits. As a result, some face the threat of fiscal collapse. Whatever may be happening at the international level (eg, at the BCBS), national reviews of financial regulation have been delayed substantially. Whether intentionally or not, they are adopting policies that lead to beggar-thy-neighbor currency devaluations as they seek to fuel an recovery with exports.

The developed economies must now work to prevent a fiscal collapse, strengthen financial regulation, and keep competitive currency devaluations in check. Ironically, these are similar to those faced by developing nations in the 1980s. When I was working on these problems, political intervention in economic policy had become entrenched in the nations of Latin America and Eastern Europe. Many governments found themselves unable to collect sufficient revenues because they invested funds in inefficient projects or lacked a functioning tax-collection system. The financial systems in many of them were also vulnerable to shocks: in some cases no distinction was drawn between the central bank and government-affiliated banks; in others, private-sector banks lacked adequate credit management and tended to go overboard on lending, yet there was no deposit insurance or lender of last resort. Furthermore, many of these countries sought to enhance international competitiveness by devaluing their currencies. Inasmuch as the advanced nations now face the same set of problems as the “developing” countries did more than 20 years ago, it should hardly be surprising that the emerging economies are taking a leadership role in the global financial economy.

## G7’s role in coordinating exchange rate policy

Does this imply that the G7 is no longer necessary? There has been criticism in the financial media of the endless rise in the number of international conferences, coupled with arguments that the G7 no longer has a role to play.

Some in Japan believe the G7 should be preserved as a forum for the coordination of exchange rate policy. Although the foreign exchange market is a global one spanning both industrialized and emerging economies, it is only the former that have committed to its flexibility. Furthermore, the financial markets and institutions of the industrialized nations have an extremely important role to play in cross-border capital flows. Given that the these countries have tended towards policies that are in nature to devaluations, it may be reasonable to argue that discussions among the G7 nations, which account for the major currencies, should be used to maintain the stability of global capital flows and check the beggar-thy-neighbor policies.

However, inasmuch as exchange rate policy is more important for emerging economies, it should be discussed by the G20 rather than the G7, and it does not represent an argument in favor of the G7’s continued existence.

Exchange rate policy tends to be a key domestic policy tool in emerging economies. It is often the case in these countries—whether because of underdeveloped domestic markets or restrictions on cross-border capital transactions—that exchange rate policy substitutes for a standard monetary policy. Exchange rate policy under such constraints is a particularly important issue for emerging economies. And inasmuch as demand from those nations is driving the world economy, evaluating the exchange rate policies from a global perspective (not just as domestic policies) also has significant implications for the stable management of the global economy. Discussions of such issues at G7 meetings, where the concerned parties are absent, can result in nothing more than “indirect expressions of opinion” and are unlikely to lead to meaningful policy responses.

For emerging economies, exchange rate policy also represents a longer-term means of correcting imbalances in the current accounts. In the short term, I am skeptical about the ability to rectify the imbalances by adjusting exchange rates. In the longer term, however, such adjustments may bring about changes in the industrial mix of emerging economies or prompt the redistribution of global production centers. Accordingly, we need to discuss exchange rate policy in the emerging economies as a longer-term tool for addressing the imbalances. G20 meetings, at which countries on both sides of the imbalances can exchange opinions, clearly offer the potential for more efficient and constructive debate.

## G7’s role in coordinating financial regulation

While I have doubts about the need to preserve the G7 as a forum for coordinating exchange rate policy, I think it could play a role as a forum for coordinating financial regulation. This is because the G7 nations maintain a substantial competitive advantage in the global financial system in terms of their trading and business presence and their capacity for regulation and policy (Exhibit 2).

The G7 nations have the world’s largest and most sophisticated financial markets. While markets in some of the emerging economies are growing rapidly, they often remain under the strict control of local authorities, and there are few examples of a wide range of markets having

Exhibit 2. Financial assets in global major markets

| | 2007 | 2008 |
|---|---|---|
| US | 60.4 | 54.9 |
| EU | 43.6 | 42.0 |
| Japan | 28.7 | 26.3 |
| China | 14.4 | 12.0 |
| UK | 8.0 | 8.6 |
| Latin America | 4.1 | 3.9 |
| Emerging Asia | 4.2 | 3.8 |

(Market Value : Trn US dollar)

| | 2008 |
|---|---|
| US | 385 |
| EU | 314 |
| Japan | 533 |
| China | 278 |
| UK | 326 |
| Latin America | 119 |
| Emerging Asia | 232 |

(Ratio to GDP : %)

Source: "Global Capital Markets", McKinsey Global Institute, 2009

developed in a balanced fashion. Too, the main players in the global financial business are based in G7 countries. The trades made by them play a determining role in the transfer of capital and risk globally. While some players in these markets do have large market capitalizations, in many cases they enjoy the de facto protection of their governments and depend on a competitive advantage in the domestic market.

Public authorities in the G7 also have a great deal of expertise. No one denies that the authorities in emerging economies have people who are just as capable as their counterparties in G7 countries. However, the G7 also have sophisticated markets and transactions as well as globally active financial players, and that's why to they may be better able to accurately identify the risks and have more practical experience in responding to those risks. This should be clear from the fact that the unconventional monetary policy implemented by the G7 was made possible by these nations' extensive knowledge of securitization markets and such functions and trades as tri-party repos and currency swaps.

Further, inasmuch as the G7 financial markets are tightly integrated by cross-border transactions and business, it is essential that these nations coordinate their financial regulatory efforts to prevent distortions in the distribution of capital and risk. Such distortions can result from regulatory arbitrage when inconsistent regulation are applied to similar markets and transactions. In this sense, the G7 could be utilized as a forum for coordinating financial regulation in the industrialized nations.

The discussion of issues regarding the global financial system by a plurality of bodies with different agendas, including the FSB and the BCBS, increases the cost of coordination and invites the risk of unnecessary delays. The recent crisis demonstrated that it can be both inefficient and inappropriate to give all G20 members a voice in discussing issues having an impact on the global financial system. After all, some of these issues involve exclusively G7 markets, transactions, or players

## G20 could provide governance

The view that the G7 should take the lead in global financial regulation has unpleasant aspects for the emerging economies, which won the ability to speak out via the G20. It is true that the emerging economies benefit from the public good of a global financial system, and it is reasonable that they would want to keep a tight leash on G7 policies, which triggered the crisis.

One possible solution would be to create a structure whereby the G20 could exert governance while leaving detailed discussion on proposals to the G7. For example, (1) the G7 chair could be required to explain G7 decisions to the G20 without delay, (2) the G20 could be given the right to question the G7 on matters of global policy and ask for reports, and (3) the G20 could be given the right to demand a postponement of G7 decisions.

Maintaining the stability of the global financial system requires that we take into account public opinion, pay attention to the needs of emerging countries, and give consideration to win the cooperation of the emerging nations in providing economic stimulus. But we must also be able to implement necessary measures quickly, with a rational perspective, and apply the expertise that is truly required. I think the G7 could play a core role in this area.

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