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G20: Hopes and Realities

By Richard W. Carney

Synopsis

Many see recent agreements struck by G20 nations as a sign of the organisation's effectiveness and a source of optimism for future international cooperation. However, there are important reasons to remain skeptical of countries' willingness to abide by such agreements.

Commentary

STARTING IN 2011, the Group of 20 economies -- or G20 -- will meet annually. The next meeting will be in Cannes, France in November. But how effective will the G20 be? To answer this, it is useful to review some of its strengths and weaknesses, and to then identify some potential problems standing in the way of reaching and implementing agreements.

Strengths and Weaknesses

The G20 is a very welcome addition to the existing panoply of international organisations. It brings together a small group of developed and emerging economies though they comprise a large fraction of the global economy in terms of economic strength. One of the clear benefits of such regular international meetings among a smaller group of nations is that they help to reduce the transaction costs of negotiating agreements, enhance the sharing of information that is not publicly available, as well as improve monitoring and, if appropriate, coordinating punishment of countries that fail to comply with agreements.

However, the G20 has some important weaknesses as well. It does not have a formal voting mechanism by which agreements are ratified; countries voluntarily choose whether to implement them. As a result, countries' domestic political arrangements prevail when determining whether to implement and abide by these agreements. Because membership includes both developing and emerging economies, as well as democracies and non-democracies, there are substantial differences both in the structure of the domestic economies and the political groups that wield power. Not only does this complicate the task of reaching agreements, but also whether countries are likely to sincerely implement them if agreements are struck.

Best Practices and Standards

After the financial crises of the 1990s, most notably the Asian Financial Crisis, the leading institutions with influence over the global financial system reinvigorated the development and implementation of universal standards of best practice in such areas as corporate governance, financial accounting, data dissemination, and banking. These institutions included the US Treasury, US Federal Reserve, G7/G8, the International Monetary Fund (IMF), Bank for International Settlements and the World Bank. The aims of this group shifted

from “liberalise the market”, as embodied in the Washington Consensus, to “standardise the market” on a global scale. To implement and enforce adoption, the IMF would conduct surveillance of countries’ compliance and make public the results.

Enforcement would occur through the response of financial markets. These core standards have been supplemented and refined with additional codes from private sector agencies such as the International Accounting Standards Board, the International Organisation of Securities Commissioners, the International Federation of Stock Exchanges, and the Institute for International Finance.

The main consequence of these new standards and surveillance mechanisms is to pull countries toward the Anglo-American model of finance capitalism, and its emphasis on financing through securities markets. The core feature that distinguishes Anglo-American capitalism from others is the structure of corporate ownership.

Corporate Ownership Differences

In the US and United Kingdom, numerous shareholders own a small piece of an enterprise – this is referred to as diffuse ownership. In this situation, no single individual can control the corporation, thus all owners/investors prefer that managers are transparent about how business is conducted, that boards of directors are independent from management (to prevent manipulation that favours managers over owners); that audits are conducted by an independent accounting firm; and that strong legal protections exist for minority shareholders. All of these regulatory features lead to a greater reliance on financing via securities markets, and as a result, bolster investment banking activities.

But concentrated ownership is the more common type of ownership found around the world; usually only one or a few actors (e.g. family, government, individual) own enough shares of an enterprise to effectively control it. Countries with more concentrated ownership tend to be less interested in Anglo-American regulations for a variety of reasons.

These include the following: (1) dominant owners tend to monitor their firms closely, hence they do not rely on the share price as a quick indicator of the firm’s performance and do not want to reveal information to their competitors (or often to the general public); (2) concentrated ownership facilitates the construction of corporate groups which are useful for internalising factor markets when the costs of contracting outside the firm are high; (3) corporate groups with pyramidal structures also enable owners to magnify the assets under their control and generate higher profits both through the ownership of larger corporate groups as well as via tunneling of funds from firms at the bottom of the pyramid to the holding company at the top; (4) governments may wish to control the largest corporations for a variety of political reasons (e.g. job creation and/or preservation) and economic reasons (e.g. to move an economy up the value chain more quickly than might otherwise occur); and (5) diffuse ownership would enable foreign actors to gain a majority stake in domestically important enterprises.

Banking Differences

Banking is another area where agreement may occur on paper, yet compliance may be lacking. Emerging economies following a state-led development strategy similar to Japan’s (e.g. China) may encourage overlending and overborrowing to move the economy more quickly up the value chain. This may occur through direct government control of banks, or via government policies that encourage investment by privately owned banks in key sectors. But whatever the mechanism, it is clear that faithful compliance with international rules that seek to bolster banks’ core capital is unlikely to occur. Such international standards are more likely to be complied with by banks in the advanced economies since they are not trying to catch up.

Thus, the G20 is a much needed forum for addressing international financial issues. But domestic political and economic realities should curb our expectations that universal standards of best practice will be sincerely implemented.

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