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Veröffentlichungsversion / Published Version
Stellungnahme / comment

SWP Comments

Stiftung
Wissenschaft und
Politik

German Institute
for International and
Security Affairs

The G-20 and the Dilemma of Asymmetric Sovereignty

Why Multilateralism Is Failing in Crisis Prevention

Heribert Dieter and Maria Krummenacher

The Group of Twenty (G-20) is not able to move forward with the reforms necessary to prevent future financial crises. Successes achieved in crisis management cannot be transformed into joint crisis prevention. The global regulation of financial markets, agreed upon at previous G-20 summits, was intended to make the international financial system more stable and more resilient against future crises. Alas, the expectations were unfulfilled. At least as serious are the failure of the Doha Round and the incapability of the G-20 to prevent it, despite the frequently voiced commitment to a multilateral order. The structural crisis in current global regulation is not least the result of an asymmetric sovereignty in financial politics: States possess only marginal influence on international financial markets, but they are liable in times of crisis. The result is a renationalization of financial policies. At the same time, the increasingly critical perception of globalization, in particular in societies of the Organisation for Economic Cooperation and Development (OECD), complicates the further evolution of the multilateral trade order.

Supranational regulation of a range of issues has been on the agenda of international politics for more than two decades. "Global Governance," particularly in economic affairs, was considered a promising concept. The development of shared norms and standards in finance should have helped to reduce risks and prevent future crises. This concept was embodied in the foundation of the G-20 in 1999 as a reaction to the financial crises of the late 1990s. In the beginning, G-20 meetings were limited to finance ministers, and it was not until November 2008 that they included heads of state and government. This was deemed a breakthrough by some observers: Finally, the problems of increasingly interdependent economies would be solved at the global level.

The crisis management of the G-20 raised hopes

Initially, the G-20 fulfilled expectations. The global economic and financial crisis was managed without a relapse to protectionist

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trade policies or harmful competitive devaluations. From 2008 to 2011, the G-20 was able to implement some significant steps, for example the modernization of the International Monetary Fund. At the G-20 summit before last, in Cannes in November 2011, the development of shared rules for the financial markets was still high on the agenda. But only non-binding memoranda of understanding were agreed upon.

In the two years since the G-20 summit in Cannes, some countries have chosen to go their own way, and it has become evident that there will be no joint approach to the regulation of financial markets. Notably, the United States (US) has not only enacted unilateral reforms of its financial markets but has also eliminated one of the established pillars of financial regulation. Authorities in the US no longer accept the so-called home country principle and have shifted unilaterally to the host country principle, according to which banks operating in the US must also hold capital in the US. The US has terminated the former consensus of the OECD countries by implementing the host country principle in banking supervision: Financial institutions are being supervised where they operate, not in the country where their headquarters are located. This has far-reaching consequences that will lead to a segmentation of markets. In the future, Deutsche Bank, for instance, will have to hold capital in New York for its American business – rather than in Frankfurt as had been the case up to now.

Just like the US, more countries have chosen individual national paths for their financial policies. For example, right from the beginning of the crisis, Brazil had raised a tax on capital inflows at rates of 2 to 6 percent and only abandoned this measure on June 5, 2013. Switzerland has chosen special capital requirements for its two largest banks, UBS and Credit Suisse, thereby deviating strongly from the standards of the Basel Committee of Banking Supervision. Whereas large banks will need to be holding 13 percent capital by the end of the current decade, according to the set of measures known as Basel III, Swiss banking supervision has enforced much higher capital requirements and is demanding 19 percent of risk-weighted assets from its two largest banks.

Liability in the event of a crisis

What is the reason for this development? Why do countries seem to lose faith in multilateral approaches, not only, but also in the regulation of financial markets? One important aspect is the largely dissimilar experience with financial crises. For the societies of countries with very large financial sectors – Switzerland, but also Great Britain – the crisis of 2008 and 2009 was a traumatic experience that the affected societies do not wish to repeat. The fiercer the crisis and the closer the abyss, the stronger the willingness of these societies not to settle for a global minimal consensus in financial regulation.

Of course, a set of rules for financial markets in particular is not only about the implementation of internationally agreed upon regulations, but also about the liability for adverse developments. In the event of a crisis, governments are at least partly responsible for the mistakes of their banks. The crises of the last years have shown this very clearly. Whether in Ireland, Spain, the US, or Belgium, governments have taken great financial risks to prevent the collapse of their financial systems.

For numerous governments, the internationalization of financial markets has led to a peculiar as well as precarious situation: Although countries possess only indirect influence on the international negotiations of financial regulation, they are individually liable in the event of a crisis. Their sovereignty is thus asymmetric: The governments of sovereign states lacked the instruments to minimize the risks that come along with their banks' business; still, they were held accountable. The resulting situation has become both politically unsatisfying and threatens the legitimacy of governments. Some G-20 states have responded with the

unilaterally implemented measures sketched above.

In principle, individual states would indeed have had the ability to tighten their financial market regulations well before the recent crises in the US and in Europe. Thereby, they would have lowered the risks for their public finance. However, before the outbreak of the crises, it was politically difficult to find support for a prudent policy. Banks successfully referred to the competitive environment in which they have to operate and pointed to the liberal banking supervisions in other countries. So, prior to the crises, we saw a leveling of the supervision to the lowest common level, which, however – as we know today – was highly inadequate.

A second reason for the growing interest in the re-nationalization of financial politics is the experience from the bankruptcy of Iceland's banking system. The three major Icelandic banks were initially growing rapidly abroad, implementing daring business models. Equally quick was their demise as all three banks slipped into bankruptcy. The assumption that a state will guarantee the liabilities that its insolvent banks have in other countries was plausible until Iceland failed to honor the obligations of its banks. The events in Iceland have weakened this expectation. The faith in guarantees of national governments – a central element of the home country principle in banking supervision – has been fundamentally shaken. The bankruptcy of Cypriot banks, although somewhat different in detail, has fuelled further doubts. That is one more reason why the US is shifting toward the host country principle.

Why do global approaches fail?

Yet, tightening the rules for financial market regulation is not the only field where the G-20 is failing. Despite the mantra-like repetition of memoranda of understanding, the trade ministers of the G-20 have not been able to overcome their conflicts of interest and reach a settlement in the Doha Round of the World Trade Organization (WTO). What are the reasons for this failure?

Although the G-20 managed to prevent a revival of protectionist measures on a broad front in the midst of the crisis, there is a large gap between the announcements of the G-20 and quantifiable results in trade policy. There is not one final communiqué that lacks a clear statement stressing the importance of the WTO and the necessity to conclude the Doha Round. Nonetheless, the reality of trade policy looks very different. All the states that are preventing the conclusion of the Doha Round through their vetoes are members of the G-20.

Despite there being little public information available on the reasons for the deadlock in the Doha Round, it is known that the US, Brazil, and China are blocking its conclusion. The emerging economies Brazil and China oppose the US's demand for the complete elimination of tariffs on industrial goods. Conversely, the US resists the request to comprehensively abandon subsidies to the agricultural sector.

Thus, the Doha Round is not concluded because three important members of the G-20 no longer believe in multilateral solutions and would rather engage in preferential agreements. For experts in the field of international trade, this is a paradox. There is a broad consensus that a single rulebook for international trade would facilitate economic growth and contribute to a worldwide increase in prosperity. This, however, cannot be said for the currently popular free trade agreements. So why are the countries in the G-20 incapable of further developing the common rules for international trade?

One explanation is the lack of a hegemonic power that is willing to guarantee compliance with the rules of the game, but at the same time establish a system that provides member countries with sufficient economic benefits. In any event, this is how the postwar economy emerged: The US enforced the system of Bretton Woods and made sure that the participation in this economic regime remained attractive. Of

course, the Bretton Woods regime never was a truly global system, since member countries of the Council on Mutual Economic Assistance did not participate. Still, within the bipolar order of the Cold War, the US managed to keep the system open and stable.

After the collapse of the USSR and the following short-lived "unipolar moment" (Charles Krauthammer) of complete hegemony of the US, the multilateral order was being advanced until 1995, the founding year of the WTO. Since the turn of the millennium and the parallel emergence of a multipolar order, nearly all attempts to organize cooperation without hegemony (Bob Keohane) have failed. The present multipolar world is characterized by superficial cooperation. Global Governance, whether in policies to prevent further climate change or in economic policy, remains on hold. Even worse: The world is returning to regulation on the level of the nation-state and non-cooperation. The American political scientist Ian Bremmer refers to the resulting situation as "G-Zero," an era in which groups such as the G-20 will no longer play a vital role.

The negative perception of the international division of labor

Apparently, there is no such thing as an identity of interests of individual states, as assumed by the advocates of global regulation and global governance. In other words: The gap between the preferences of individual states is widening rather than narrowing. However, governments must respect the preferences of their societies in the formulation of policies if they do not wish to lose legitimacy. Then again, the different preferences of societies are the immediate result of severely diverging perceptions of the international division of labor. Even in the G-20, individual societies have very different perceptions of the effects of globalization and its economic effects.

In Europe and the US, many people are increasingly critical of the international division of labor, if not outright hostile to globalization. According to a number of surveys, only about one-fifth to one-third of the respondents in OECD countries see greater opportunities than risks in globalization. Even in Germany, numerous politicians and citizens have been critical of globalization, although Germany strongly benefits from open markets and the resulting intensification of international trade.

Without a political anchoring in the member states, the G-20 has no future

The unfavorable perceptions of globalization and the outlined asymmetric sovereignty have resulted in a standstill in the G-20. Instead of a further development of the multilateral order, at best the status quo will be preserved. This is why we can expect nothing substantial – at least in terms of economic policy and financial regulation – from the G-20 summit in St. Petersburg on September 5 and 6.
The structural impediments to successful financial regulation and trade policies on a supranational level cannot be overcome by the heads of government and state of the G-20. At least there is some hope in those areas where the countries of the G-20 have identical interests. This applies primarily to measures to close down tax loopholes.
In 2008, ambitious expectations of a comprehensive reorganization of international trade relations through the G-20 were raised. Unfortunately, the G-20 cannot and will not deliver on crisis prevention. Today, more modest goals will have to be set. The key obstacle to success in the further development of global rules in trade and finance can be found in the G-20 societies themselves. Perceptions about globalization need to be addressed by policy makers at the national level, as do the widespread reservations about the international division of labor in the OECD countries. If societies continue to show diverging preferences, the development of comprehensive global economic governance in the G-20 will be all but impossible.

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ISSN 1861-1761

(English version of SWP-Aktuell 53/2013)