JOURNAL OF ECONOMIC ISSUES
Vol. XLV I No. 2 June 2012
ISSN 0021–3624/2011 $9.50 + 0.00
DOI 10.2753/JEI0021-3624460223

The Governance Response to the Great Recession: The "Success" of the G20

Jakob Vestergaard and Robert Wade

Abstract: Since its upgrading to heads of government level in late 2008, the G20 claims to be the steering committee for the world economy. It claims three specific big successes: stronger international financial regulation, including the Basel 3 Capital Accord; more effective macroeconomic coordination; and governance reforms of the Bretton Woods organizations. This paper challenges all three claims, but concentrates on the Basel 3 Accord. The modesty of the achievement leaves the world vulnerable to more multi-country financial crises, and testifies to the ineffectiveness of the G20 as presently constituted.

Keywords: global economic governance, G20, international banking regulation, recession

JEL Classification Codes: E32, E44, E6, F5, G2

> *"It's a bloody nightmare. The [national financial] regulators have no respect for one another at all. Each country is looking after itself" (senior executive in charge of regulation at one of the world's biggest banks, talking about the implementation of Basel 3 rules, in Brooke Masters, "Conflicting signals," Financial Times April 2, 2012, 9.)*

As the Atlantic world economy trembled through 2008 the governments of Australia and Canada energetically pressed the reluctant administration of U.S. President George Bush to upgrade the existing G20 of finance ministers and central bank governors to heads of government level, for the purpose of strengthening inter-state

Jakob Vestergaard is a senior researcher at the Danish Institute of International Studies. Robert Wade is a professor of political economy at the London School of Economics. *This paper was presented at the annual meeting of the Association for Evolutionary Economics, January 6-8, 2012 in Chicago.*

crisis coordination. Following the first summit in November 2008 in Washington, DC, the communique from the third summit (Pittsburg, September 2009) declared that the G20 leaders' forum would henceforth be "the premier forum for our international economic co-operation." With this the G20 promoted itself from "crisis committee" to "steering committee" for the world economy.

How has the G20 performed? The G20 itself identifies three major successes. "The concerted and decisive actions of the G20," it says, have "already delivered a number of significant and concrete outcomes":[1]

- The scope of financial regulation has been "largely broadened" and prudential regulation and supervision "have been strengthened."
- "Great progress" in policy coordination has been achieved in and through the "framework for a strong, sustainable and balanced growth" designed to "enhance macroeconomic cooperation."
- Global governance has "dramatically improved" to better "take into consideration the role and needs of emerging and developing countries, especially through the ambitious reforms of the governance of the IMF and the World Bank."

If only. Closer scrutiny of each achievement suggests at best modest progress, a long way short of "significant and concrete outcomes." This paper assesses the G20's claim to effectiveness in the domain of financial regulation, focusing on its role in the negotiation of a new standard in international banking regulation, the Basel 3 Accord. There is a close overlap between the membership of the G20 and the membership of the Basel Committee, which comprises the 19 member countries of the G20 plus a handful of additional European countries and two financial hubs in Asia (Hong Kong and Singapore). The Basel Committee negotiated the new accord.

Basel 3 is a "best" case for assessing G20 influence, both because the G20 members dominate the Basel Committee and because even scholars broadly critical of the G20's results in other areas cite Basel 3 as a G20 success story.[2] For example, Domenico Lombardi argues that the failure to reach an agreement on global imbalances "should not overshadow the rapid agreement achieved with regard to the Basel 3 Accord, which would not have been possible without the political momentum provided by the G20 leaders" (Lombardi 2010; see, also, Helleiner 2011). It may well be true, as Lombardi says, that the Basel 3 Accord would not have been reached in the course of a year without the political momentum provided by the G20 summit process; but speed alone hardly constitutes success.

So slight were the Basel 3 regulatory changes that 20 leading finance professors published a scathing critique in a letter to the *Financial Times* (FT).[3] They warned that Basel 3 fails to "eliminate key structural flaws in the system" and therefore is "far from sufficient to protect the system from recurring crises" (Admati et al. 2010). The continuing crisis of the European banking system — as of December 2011 threatening to trigger another global recession — further testifies to the fact that the successful negotiation of the Basel 3 Accord did little to enhance the prospects for stability of the international financial system, which was its objective.

Here we identify several fundamental problems with the content of the Basel 3 Accord. We first discuss the main features of the Basel 3 Accord and their shortcomings. Then we discuss Basel 3 in light of the ongoing Eurozone crisis. We conclude that Basel 3 is an intensification of its (failed) predecessor rather than a departure from it. Even if fully implemented it would leave the banking sector dangerously fragile. It can hardly be held up as an example of "G20 effectiveness."

The Basel 3 Accord

The overall objective of the Basel 3 Accord is to promote "a better balance between banking sector stability and sustainable credit growth" (Basel Committee on Banking Supervision [BCBS] 2010a). To achieve this the Accord demands higher levels of capital reserves and introduces new measures to moderate the credit cycle.[4] The main shortcomings are that changes in capital adequacy requirements are far too small, that measures introduced to moderate the credit cycle are marginalized and insignificant in scale, and that the deadline for implementation of these supplementary measures has been pushed almost a decade, to 2019.

The Capital Inadequacy Ratio

The minimum capital requirement remains at an aggregate 8% of risk-weighted assets, as in Basel 1 and 2. The new Accord does, however, strengthen the requirements in terms of the *quality* of these reserves. Capital is divided in two categories: *Tier 1 Capital* and *Tier 2 Capital*, the former being higher quality types of capital than the latter. Tier 1 Capital is then split into two sub-categories: *Common Equity* and *Additional Going-Concern Capital*, with the former considered higher quality than the latter. The two main changes are that the share of Tier 1 capital in total capital is raised from 50% to 75% and that the share of common equity in Tier 1 capital is also raised from 50% to 75% (see Table 1). Overall, common equity — which is regarded as the most loss-absorbing form of capital — increases its share in *total* capital from 25% to 56%.

In addition to these revised minimum capital adequacy requirements, Basel 3 requires that banks hold a so-called "capital conservation buffer" of 2.5%, also in the form of common equity, in order to withstand periods of stress. When banks draw upon this buffer, they will be subject to a set of constraints on their earnings distributions (dividends and bonus payments, for instance) (BCBS 2010a, §50). This brings the total common equity requirements to 7%, as compared to 2% under Basel 2. The Financial Times referred to this by reporting that global banking regulators had agreed to "triple the size of the capital reserves that the world's banks must hold against losses" (FT 2010). But, as Martin Wolf dryly noted, while tripling sounds impressive, tripling almost nothing still leaves you with almost nothing (Wolf 2010).

Table 1. Capital Requirements (%), Basel 2 vs. Basel 3

Capital	Basel 2	Basel 3
Common equity	2	4.5
Other Tier 1	2	1.5
Total Tier 1	4	6
Tier 2	4	2
Total Tier 1 + Tier 2	8	8

To appreciate the insignificance of the proposed increases in capital reserve requirements consider the following two points. First, with respect to Tier 1 capital, Basel 3 raises requirements to 8.5% (if the capital conservation buffer is included), which is below the 10% held on average by U.S. banks in recent decades (Johnson 2010a, 2010b). This modest requirement for Tier 1 capital does not match well with U.S. Treasury Secretary Timothy Geithner's repeated emphasis on "capital, capital, capital," as the appropriate response to the crisis.

Second, the proposed capital reserve requirements are considerably below what the emerging consensus in mainstream financial economics would suggest. Scholars argue that between 15 and 20% Tier 1 capital should be held by banks in good times (Hanson, Kashyap and Stein 2010; Miles, Marcheggiano and Yang 2011). Andrew Haldane of the Bank of England stresses that "even once Basel 3 is in place, an unexpected loss in the value of a bank's assets of 4% will be enough to render it insolvent" (Haldane 2011, 14). We agree with Martin Wolf that the Basel 3 capital adequacy ratio is better described as a "capital *inadequacy* ratio" (Wolf 2010, emphasis added).

The Marginalization of Counter-Cyclicality

Often the debate on capital adequacy requirements is framed as a matter of limiting leverage rather than as a matter of moderating the cycle. This, in turn, leads to proposals to simply *raise* capital adequacy ratios (CARs). Raising them is necessary but not sufficient, however. CARs must be revised in a manner that makes them counter-cyclical as opposed to pro-cyclical. This means that CARs need to be specified in a manner that moderates excessive lending in the boom *and* automatically makes built-up reserves available during busts. This measure would moderate the economic cycle by dampening the credit expansion in the boom, as well as the subsequent credit contraction during the bust. Charles Goodhart and Avinash Persaud (2008) have proposed a simple framework by which CARs are raised by a ratio linked to the growth of the value of bank assets. By this mechanism, capital adequacy requirements for a given bank would be raised automatically by, say, 0.5% for each 1% excess growth in the value of the bank's assets. If a bank was to grow its assets at a rate of 20% above its allowance — in the context of a booming economy — its minimum capital adequacy requirement would rise from, say, 8 % to 18%.

In the immediate aftermath of the onset of the global financial crisis a consensus seemed to be emerging in policy debates on the need for such countercyclical financial regulation (Brunnermeier et al. 2009). Soon, however, the concern with counter-cyclicality was relegated to the margins. In the published Accord, the countercyclical buffer of Basel 3 is a measure authorities may *consider* introducing on a case-by-case basis *if* they consider credit creation to be excessive.[5]

The problem with this countercyclical buffer is that it is "too little, too late." Regulators should have revised the capital reserve requirements more fundamentally to make them countercyclical at their root, not a marginal "add-on" to the existing framework, an "optional extra" (Persaud 2010). Moreover, the counter-cyclical buffer was set at a very low level, at a specified range of zero to 2.5%.[6] A countercyclical buffer introduced on a discretionary basis, when credit growth is deemed excessive, at a level as modest as this, cannot be expected to achieve much in terms of moderating boom and bust cycles.

Postponing Implementation

Since early 2010, the banking industry lobbied hard to postpone the implementation of whatever Basel 3 Accord would eventually be reached (Lall 2011). It succeeded: full implementation is postponed from the end of 2012 to between 2016 and 2019 (see Table 2).

To achieve this postponement the banking industry argued that premature implementation of new regulations could threaten the fragile economic recovery. The main lobbying group of large international banks, the International Institute of Finance (IIF), released an impact assessment in June 2010 stating that the Basel 3

Table 2. Implementation Plan for the Main Elements of Basel 3

	How much?	When?
Minimum capital reserves	Still 8 %, but higher quality	2013–2015
Capital conservation buffer	2.5 %	2016–2019
Countercyclical capital buffer	0–2.5 %	2016–2019
Leverage ratio	3 %	2018

proposals would cause a cumulative reduction in GDP of $920 billion — equivalent to 4.3% of GDP by 2015 in the Eurozone alone. The United States would see a reduction of $951 billion or 2.7% of GDP. Together this would amount to more than 9 million fewer jobs created, the IIF stressed (Bryant and Masters 2010).

These assessments were not confirmed by independent analysis. On the contrary, the chief economic advisor to the Bank of International Settlements, Steven Ceccheti, suggested in May 2010 that "the net impact of the Basel committee reforms on growth will be negligible" and "our preliminary assessment is that improvements to the resilience of the financial system will not permanently affect growth — except for possibly making it higher" (Giles 2010).

There is considerable risk that even the limited revisions agreed upon in the form of the Basel 3 Accord will never come into effect. In each of the last seven international financial crises, plans for a "radical shake up of international regulatory and monetary arrangements have made surprising progress, only to be tidied away and stuffed in the bottom drawer once the economy recovered" (Persaud 2010).

Basel 3 and the Eurozone Crisis

When launching the Basel 3 Accord to the world in September 2010, Nout Wellink, Chairman of the Basel Committee, stressed that it was "designed to protect against future crises" and that the goal was "to ensure that all material risks are captured" (BCBS 2010b, 1, 2). He affirmed the conviction that financial risks could be known, calculated and carefully managed. But this is Alice-in-Wonderland. In the real world we do not have a good grip on the *dynamics* of financial risk. "No financial or bank crisis has ever occurred from something ex-ante perceived as risky," observes Per Kurowski (2010). On the contrary, "they have all resulted, no exceptions, from excessive lending or investment in something perceived as not risky" (Kurowski 2010).

A prime example is the treatment of sovereign debt in the Basel 2 Accord. Such debts were given a zero risk weighting in Basel 2 capital requirements, reflecting the assumption that sovereign debt was risk free: governments would always pay, never default. In today's predicament the assertion seems absurd. Greece may well default on its sovereign debts, and the list of default-candidates is expanding to major economies: Italy, Spain, even France. Nevertheless, the Basel 3 Accord "continues the tradition of encouraging private institutions to invest in sovereign debt that is rated above double-A minus, by classifying it as risk free" (Helleiner 2011).

Of course, agreement on Basel 3 was reached before the Greek sovereign debt crisis developed into a full-fledged European sovereign debt crisis, so perhaps G20 leaders can be partially excused on that account. Be that as it may, it is troubling that the more fundamental lesson at stake has not been learned: international financial regulation remains predicated upon the belief that financial risks can be known and "sophisticatedly" managed, individually, by the financial organizations themselves. Yes, there is a need for enhanced supervision and strengthened standards, they and the regulators say, but at the end of the day, the paradigm of bank self-regulation is sound.

When discussing whether the Basel 3 Accord was an adequate response in light of the global financial crisis it is important to distinguish between errors of commission and errors of omission. The problem with Basel 3 lies in sins of omission: not so much in what it does as in what it does not do. Despite much rhetoric to that effect, Basel 3 was not a genuine attempt to launch a new approach to financial regulation. A new approach would have entailed significant, mandatory recapitalization of banks — if necessary in the form of public equity — by the end of 2010, as well as making capital adequacy requirements countercyclical at their core. That would indeed have gone a long way to lessen the severity of the current banking and sovereign debt crisis in Europe.

Conclusion

Even in the run-up to the Seoul summit in November 2010, the G20 was depicted by commentators as "divided, ineffective and illegitimate" (Rachman 2010). The summits in Seoul (November 2010) and Cannes (November 2011) only heightened the impression. Not only with respect to Basel 3; also with respect to the other two problem areas where the G20 leaders claim to have exercised a major prodding and steering role — global imbalances and voice reform in the Bretton Woods organizations — the reality is that the structures have changed little (Chin 2011; FT 2010; Malloch-Brown 2010; Vestergaard and Wade 2011; Wade and Vestergaard 2012). The bottom line is that the G20 has so far largely failed to have substantial political impact on any of the key problems roiling the global economy. It has shown itself to be little more than a "toothless talk shop" many feared it would be, rather than an apex steering committee (Wolverson 2010).

In this paper we have examined the Basel 3 Accord, which the G20 has held up as one of its finest achievements. In the words of Jean-Claude Trichet, Chairman of the Basel Committee Group of Governors and Heads of Supervision, the Basel 3 Accord would "promote the long term stability of the banking system" by launching "a new regulatory landscape" that "reflects the key lessons of the crisis" (BCBS 2010c). In reality, Basel 3 is little more than a modest intensification of Basel 2. First, the agreed increase of capital reserve requirements is far from sufficient. Second, the provision for counter-cyclicality is only marginal, an add-on, instead of a new core principle. Third, implementation of new regulatory measures has been postponed until the period from 2016 to 2019, as a result of intense banking industry lobbying (Lall 2011).

Eric Helleiner poses the obvious question: "[H]aven't G20 policy-makers been working diligently to make the global financial system safer and more shockproof" over the past three years when most of the West has experienced an economic crisis more severe than any since the Great Depression? Yes, they have, he continues, but "unfortunately it is far from clear that the thousands of hours of work that have gone into post-crisis regulatory reform have made the system much safer from the kind of instability we are now facing" (Helleiner 2011).

Proponents of the G20 may object that the G20 cannot be held responsible for the failings of the Basel Committee, which is formally responsible as well as politically in the driver's seat. But keep in mind the earlier point that the members of the Basel Committee are, by and large, the finance ministers and central bank governors of the G20 countries.[7] If the G20 cannot incline a committee of its own finance ministers and central bank governors to deliver a significant result on what is one of the single most important reform agendas – international banking regulation – it makes little sense to think of the G20 as a "steering committee" for the global economy.

Notes

1. These quotes are all from the official G20 website. See, www.g20.org (accessed December 14, 2012).
2. In case study methodology terms, ours is a "critical case study" (Flyvbjerg 2004, 426). In other work, we have assessed G20 effectiveness in the areas of governance reforms of the Bretton Woods organizations (Vestergaard and Wade 2011) and global imbalances (Wade and Vestergaard 2012), and come to similar conclusions.
3. Signatories to the letter include Professor Anat R. Admati (Stanford), Professor Markus K. Brunnermeier (Princeton), Eugene F. Fama (Chicago) and Professor Charles Goodhart (London School of Economics).
4. The new measures include a countercyclical buffer, a non-risk based leverage ratio and two new minimum requirements for liquidity: the liquidity coverage ratio and the net stable funding ratio. For a more elaborate discussion of the main elements of Basel 3, see Vestergaard and Højland (2011).
5. To assist national authorities in deciding when the buffer should apply, the Basel Committee has devised a "common reference point" for measuring excessive credit growth. When credit/GDP exceeds its long-term trend with an amount assessed to be associated with a build-up of system-wide risk the counter-cyclical buffer should be activated, and vice-versa.
6. The size of the countercyclical buffer will be set by national authorities between 0 and 2.5% of risk-weighted assets and will be required to be made up of common equity (BCBS 2010a, §139 and 142).
7. Recall that the member countries of the Basel Committee are the 19 member countries of the G20 plus a handful of additional European countries (Belgium, Luxembourg, the Netherlands, Spain, Sweden, Switzerland) and two countries that are financial hubs in Asia (Hong Kong and Singapore).

References

Admati, Anat, Richard Brealey, Michael Brennan, Arnoud Boot, Markus Brunnermeier, John Cochrane, Peter DeMarzo et al. "Healthy Banking is the Goal, Not Profitable Banks." *Financial Times*, November 9, 2010.

Brunnermeier, Markus, Andrew Crocket, Charles Goodhart, Avinash Persaud and Hyun Shin (eds.). *The Fundamental Principles of Financial Regulation*. London: Center for Economic Policy Research, 2009.

Basel Committee on Banking Supervision (BCBS). Basel III: *A Global Regulatory Framework for More Resilient Banks and Banking Systems*. Basel: Bank of International Settlements, 2010a.

——. *A New Regulatory Landscape. Remarks by Nout Wellink.* September 22, 2010b.

——. Press Release: The Group of Governors and Heads of Supervision Reach Broad Agreement on Basel Committee Capital and Liquidity Reform Package. Basel: Bank of International Settlements, 2010c.

Bryant, Chris and Brooke Masters. "Bankers Fear Effects of Basel Rules." *Financial Times*, June 10, 2010.

Chin, Gregory "Global Imbalances: Beyond the 'MAP' and G20 Stovepiping." *CIGI Commentaries*. Toronto: Centre for International Governance Innovation, 2011.

Financial Times. "G20 Show How Not to Rule the World." *Financial Times*, November 12, 2010.

Flyvbjerg, Bent. "Five Misunderstandings About Case Study Research." In *Qualitative Research Practice*, edited by Clive Seale, Giampetri Gobo, Jaber Gubrium and David Silverman, pp. 390-404. London: Sage, 2004.

Giles, Chris."Bankers' 'Doomsday Scenarios' Under Fire from Basel Study Chief." *Financial Times*, May 31, 2010.

Goodhart, Charles and Avinash Persaud. "A Party Pooper's Guide to Financial Stability." *Financial Times*, June 4, 2008.

Haldane, Andrew. "Control Rights (and Wrongs)." Wincott Annual Memorial Lecture in Westminster, London. October 24, 2011.

Hanson, Samuel, Anil Kashyap and Jeremy Stein. "A Macroprudential Approach to Financial Regulation." Chicago Booth Research Paper no. 10-29. 2010. Available at http://papers.ssrn.com/so13/papers.cfm?absract_id-1708173, Accessed February 17, 2012.

Helleiner, Eric. "Should We be Feeling More Secure? The Limits of International Regulatory Reform." *CIGI Commentaries*. Toronto: Center for International Governance Innovation, September 30, 2011.

Johnson, Simon. "Why Higher Capital Standards Are Needed.") *New York Times*, July 29, 2010a.

——. "Basel 3: The Fatal Flaw." *The Baseline Scenario*, September 16, 2010b.

Kurowski, Per. "The Bare-Naked Basel Committee." *Blogpost* September 10, 2010. Available at https://subprimeregulations.blogspot.com/2010/09/bare-naked-basle.committee.html. Accessed October 10, 2010.

Lall, Ranjit. "Reforming Global Banking Standards: Back to the Future?" In *Governing through Standards: Origins, Drivers and Limitations*, edited by Stefano Ponte, Peter Gibbon and Jakob Vestergaard, pp. 75-101. London: Palgrave, 2011.

Lombardi, Domenico. "U.S. Politics after Seoul: The Reality of International Cooperation." Washington, DC: Brookings, November 23, 2010.

Malloch-Brown, Mark. "How the G20 Glasshouse Is Under Attack." *Financial Times*, November 11, 2010.

Miles, David K., Gilberto Marcheggiano and Jing Yang. Optimal Bank Capital. *Discussion Paper no. 8333*, 2011. Centre for Economic Policy Research, London.

Rachman, Gideon. "Seven Pillars of Friction." *Financial Times*, November 8, 2010.

Persaud, Avinash. "The Empire Strikes Back." *VOX*, September 14, 2010.

Vestergaard, Jakob and Martin Højland. "The New Standard in Banking Regulation: From Basel II to Basel III." In *Governing through Standards: Origins, Drivers and Limitations*, edited by Stefano Ponte, Peter Gibbon and Jakob Vestergaard, pp. 49-74. London: Palgrave, 2011.

Vestergaard, Jakob and Robert Wade. "Adjusting to Multipolarity in the World Bank: Ducking and Diving, Wriggling and Squirming." DIIS Working Paper no. 24. Copenhagen: Danish Institute for International Studies, 2011.

Wade, Robert and Jakob Vestergaard. "The Rise and Fall of the G20." Working Paper, 2012.

Wolf, Martin. "Basel: The Mouse That Did Not Roar." *Financial Times*, September 14, 2010.

Wolverson, Roya. "G20's Tepid Economic Reform." Analysis Brief. Washington, DC: Council on Foreign Relations, October 25, 2010.