



Australia's Brisbane Summit challenge: Securing G20's future

August 2014

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About this publication

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About CEDA

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Foreword: Professor the Hon. Stephen Martin, Chief Executive, CEDA



Australia has a real opportunity as the host of the G20 Brisbane Summit in November to lead global issues that have significance for both our own and the global economy.

CEDA's report, *Australia's Brisbane Summit challenge: Securing G20's future*, examines how further potential can be realised from the G20.

Australia is spending a significant amount, suggested as almost half-a-billion dollars, as host of the G20 this year. However, if the reforms proposed through a robust agenda at G20 are enacted, there is potential for a much larger economic payoff, many times this for the global economy, which will of course flow through to Australia. The central issue is making sure this potential is realised.

Australia, as the host of the Brisbane Summit, has a unique opportunity to make sure that the forum is more than a 'talkfest', and that key issues of global importance are tackled effectively.

Significant concerns at the moment are that issues such as financial system regulation reform and taxation – where substantial progress through the G20 has been achieved already – may not be taken to the next level required to ensure these issues are addressed appropriately and with the renewed rigour they need following the Brisbane Summit. For example, financial system regulation reforms pursued by the G20 following the Global Financial Crisis have been strong but largely, as to be expected, reactionary. The next step in these reforms is to address the root cause of financial crises.

The tax reform agenda also needs to be expanded to become bolder and to more comprehensively include emerging economies. At the same time, other key issues such as climate change, particularly the economic consequences as identified in a previous CEDA report, are currently not on the agenda at all.

While there has been some comment that the G20 lacks the firepower to achieve results on such matters, in reality this is a major economic issue. The Summit's key strength is it can act as a springboard to forums such as the United Nations Framework Convention on Climate Change (UNFCCC) in Paris next year.

While it can be argued the agenda needs to be narrow to ensure discussions are specific enough to get results, the current agenda needs to be more flexible and allow discussion of contentious issues to bring the global political leadership and weight they need.

I would like to thank the authors and the CEDA advisory group for their contribution to this publication. I would also like to thank the publication sponsor, Norton Rose Fulbright. Without additional support from CEDA members such as this, CEDA's research publications would not be possible.

Foreword: Wayne Spanner, Managing Partner, Norton Rose Fulbright Australia



As chair and host nation of this year's G20 Summit, Australia is squarely on the world stage and well prepared for any close analysis of its presidency.

Norton Rose Fulbright Australia agrees with the authors' sentiments in the following CEDA discussion papers that by producing an action plan for gross domestic product (GDP) growth targets and keeping the agenda narrowly focused, Australia has gone a long way to ensuring that the G20 remains a relevant and influential institution with an important role to play in long-term international governance.

Rather than overstating Australia's level of influence as a middle-power nation, it is pleasing to see us embrace our international reputation in economic forums by focusing the agenda on growth and resilience.

Further limiting the agenda to governance-focused reform topics also plays to our strengths. Provided we allow some agenda flexibility, Australia and the G20 are now uniquely positioned to generate broad and highly credible discussion.

The G20 must focus its discussion on innovative approaches to old problems. And member countries must ultimately find a way to reach a consensus on a suite of reforms and other solutions that will benefit the world as a whole. This is of particular importance for those nations that do not participate in the G20, such as some of our neighbours in the Asia Pacific, and groups that do not have as strong an economic voice.

Norton Rose Fulbright has been honoured to assist G(irls)20, a group of young women, aged 18 to 20, selected as future leaders from G20 nations, to add a unique voice to the conversation for the past five years. The diversity of opinion and commentary that G(irls)20 adds to the Summit agenda is highly relevant and critical to the advancement and economic empowerment of women.

It is understandable, and in fact commendable, that G20's recent efforts have been aimed at mitigating the worst of the Global Financial Crisis and working to prevent similar issues from happening again. The continued globalisation of financial systems and the steady shift of large capital bases to less regulated institutions mean this good work must continue.

New challenges will continue to arise. Financial incentives are now being provided by some regulators for whistleblowing, and there is an increased regulatory interest in organisational culture and business ethics.

Just as politicians need to continually consider and enact intelligent legislation, businesses need to adapt to this environment by developing their own policies and guidelines to address the demands of a changing world. We applaud the efforts the G20 has made to date to implement financial system and tax reform, and we look forward to continued innovation.

Executive summary

The Group of 20 (G20) is an international governance organisation comprising 19 countries, including Australia, and the European Union (EU). The countries within the G20 represent about 85 per cent of global gross domestic product (GDP), over 75 per cent of global trade, and 67 per cent of the world's population. G20 leaders meet annually, while its finance ministers and central bank governors meet regularly to discuss contentious policy issues that require international cooperation and decision-making. The G20 has been widely commended for the crucial role it played in mitigating the effects of the Global Financial Crisis (GFC), particularly in fostering international cooperation for financial system reform.

With the GFC behind us and the G20's financial system reform agenda ending soon, the group has been left open to criticism that the November 2014 Brisbane Summit (also known as the Leaders Meeting), which Australia is chairing, will just be a 'talkfest'. The G20's relevance and influence in the crowded international governance space is being put into question, leaving many wondering whether there is a role for the G20 to play in the future or whether it is simply duplicating the work of other more-effective organisations.

Australia has embraced the presidency of the G20 with zeal, with a narrow agenda focused on economic issues, including a growth target of raising G20 GDP by more than two per cent above expected levels over the next five years.

A growth target in itself may not be revolutionary, but by expecting each country to produce an action plan for the target, Australia has attempted to introduce accountability, setting the tone that the Brisbane Summit will not simply be a ‘talkfest’ and showing that Australia is up to the task of the presidency.

The presidency may be going well, but Australia faces the daunting task of securing the G20’s future at the Brisbane Summit. This policy perspective finds that there is a role for the G20 to play in the international governance space, despite criticism levelled at the group. It also finds that Australia, as chair of the Brisbane Summit, must rise to the challenge of ensuring the G20 remains relevant and influential as an international cooperation institution, and of keeping the financial and taxation reform agendas moving forwards constructively.

Recommendations

To sustain the G20’s role in international governance and keep its contribution constructive and relevant, as president of this year’s G20 and chair of the Brisbane Summit, Australia cannot be complacent about what has been achieved so far. Australia still has a big job to do to ensure that the G20’s future agenda addresses the shortcomings of past agendas.

Reform 1: A sustainable G20 agenda

Australia and subsequent G20 chairs should ensure that the current and future G20 agenda:

- Continues to focus on reform of policy and economic issues that have global causes and effects, and that require global coordination; and
- Is not overburdened, but has the flexibility of including highly contentious global issues for discussion due to the value of these discussions to policymakers and other groups.

This recommendation recognises the merit in having a narrow G20 agenda while playing to the G20’s strength in fostering frank and inclusive discussion that may not happen in other forums. The Brisbane Summit, being a meeting of G20 leaders, can also add political weight to issues discussed.

Reform 2: A new financial system reform agenda

To ensure financial system reform remains relevant and continues to make a difference, the G20 should:

- Assess and expand the reform agenda to guarantee that it is addressing any new problems and trends that arise over time; and
- Develop a new reform agenda to address the root causes of financial crises to reduce the risk of future crises.

As part of any financial system reform agenda, the G20 should:

- Ensure that regulatory oversight authorities continue to examine financial institutions intrusively;
- Extend the power of regulatory oversight authorities to include poorly supervised institutions, such as shadow banks; and
- Strengthen and expedite shadow banking reforms.

Many of the reforms introduced following the GFC have been enacted, and many of these with success. However, the G20 cannot grow complacent about what has been achieved so far. The G20 can add value through a new agenda addressing the shortcomings of past and ongoing financial system reforms.

Reform 3: Strengthening of the taxation regulation reform agenda

To make a difference when it comes to taxation regulation reform, and to ensure that the taxation system reflects globalisation realities, the G20 should:

- Explore the possibility of introducing new models rather than fixing current models of taxation to combat tax avoidance;
- Reform regulatory reporting authorities to allow them to inform the public and not just taxation bodies to improve transparency; and
- Seek feedback from developing and emerging nations when developing policy, and formulate a best practice approach for doing so.

These recommendations build on the current taxation reform work of the G20 and the Organisation for Economic Co-operation and Development (OECD). Australia and the G20 can both play a role in proposing a bolder agenda to address current areas of concerns.

Financial system reform and taxation regulation reform show how the G20 can make an ongoing difference, and such initiatives could be deployed in other areas of the G20 agenda. At the Brisbane Summit, Australia should rise up to the significant challenge of sustaining G20's role in international governance and securing its future by implementing these recommendations.

Contributions

This report brings together experts from the international governance, finance and taxation fields to examine the issues associated with the G20's role in today's globalised world.

In *Can the G20 ever realise its potential?* Professor Mark Beeson discusses the current state of play in international governance, G20's strengths and weaknesses given prevailing global economic conditions, and Australia's challenges in

chairing the Brisbane Summit. He argues that the G20 faces the risk of becoming unfocused if its agenda is too broad, while the difficulty of overcoming vested interests remains a challenge even with a narrower agenda. Professor Beeson concludes that Australia, as a middle-power country, may be able to display leadership at the meeting – but without support from more-powerful nations, its powers may be limited.

In *Unfinished agenda: The Brisbane G20 Summit and global financial reform*, Dr John Edwards analyses G20's role in international financial system reform during the GFC, critiques the adoption and implementation of these reforms to date – including the progress that has been made in Australia – and provides an assessment of what remains to be done. He warns that there is no place for complacency in reforming the financial system. Dr Edwards recommends that future reforms should address the root causes of the GFC and new issues that have arisen since, with a view to reducing the risk of future financial crises.

In *The role of the G20 in taxation regulation*, Professor Kerrie Sadiq discusses the inadequacies of the current international tax regime; the role that the G20, with the help of the OECD, has played in addressing tax evasion (including base erosion and profit shifting); transparency and information disclosure; and the lack of representation of developing and emerging countries at the global stage. Professor Sadiq concludes that there is more work left to be done in reforming the current taxation regime. She recommends stronger reforms, including exploring the possibility of introducing completely new models of taxation.

“Dr John Edwards recommends that future reforms should address the root causes of the GFC and new issues that have arisen since then, with a view to reducing the risk of future financial crises.”

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- Dr Susan Harris Rimmer, Director of Studies, Asia Pacific College of Diplomacy, ANU College of Asia and the Pacific, ANU;
- Geoff Allen AM, Chairman, CEDA, and founder of the Allen Consulting Group;
- Professor Glenn Withers AO, Board Member, CEDA, and Professor of Economics, Crawford School of Public Policy; and
- Dr John Edwards, Board Member, CEDA and Reserve Bank of Australia.

These distinguished experts provided guidance in the creation of the report and input into the final recommendations. However, the final report is entirely the responsibility of CEDA and of the individual authors.



CEDA overview

Sarah-Jane Derby

CEDA SENIOR ECONOMIST

The global economic architecture and political economy are constantly changing. As the world becomes more interconnected through globalisation and global economic power shifts lead to new hegemonies, it is worth assessing the traditional rules and processes governing international cooperation. Globalisation trends have meant that entities transcend national borders, alongside trade and capital flows, and no country's economy, no matter how small or distinct, exists in isolation of any other.

Global cooperation is now more important, and yet more difficult, than ever. International governance organisations such as the United Nations (UN) are grappling with the task of building consensus, while many countries and regions are taking things into their own hands through bilateral and plurilateral regional agreements. This has led to concerns about duplication and overcrowding in the international governance space.

Among the myriad organisations involved in that space, G20 has emerged as a success story for the role it played in mitigating the effects of the Global Financial Crisis (GFC) through fostering international cooperation for financial system reform. The GFC served as a reminder of the interconnectedness of global economies and the importance of having an international economic cooperation organisation able to step in with a solid agenda and drive for reform – a role the G20 performed successfully during the heights of the crisis.

The G20 may once have been everyone’s favourite international forum, but with the GFC behind us (barring some lingering effects and ongoing problems in the Eurozone), there is much debate around whether it has any role left to play now that the driving force of the crisis is gone.

This overview sheds light on this debate, in particular by assessing:

- The current and potential roles of the G20 when it comes to financial system and taxation regulation reforms; and
- Australia’s role, as host of the G20 in 2014 and chair of the Leaders Meeting (also referred to as the Brisbane Summit), in ensuring that the G20 continues to be a relevant and constructive forum.

International governance

Formed in 1999, the G20 is a relative newcomer in the international governance arena. Its precursor, the Group of Seven (G7), dates back to the 1970s when the world was facing crises due to the collapse of the Bretton Woods System, and skyrocketing oil and food prices. The seven countries comprising the G7 (i.e. Canada, France, Germany, Italy, Japan, the United Kingdom and United States) reflected the largest economies of the time.¹

The G7 was subsequently expanded into a group called the Group of Eight (G8). The G8 comprised the members of the G7 plus Russia. However, as of March 2014, Russia is suspended from the G8, making the G7 and G8 (G7/8) effectively one and the same.

The first G20 meeting occurred in Germany in 1999 in the aftermath of the Asian financial crisis. The G20 was formed as an extension of the G7 with the aim of having a more diverse group in the field of international governance,² acknowledging the rise and influence of other important emerging economies. The members of the G20 are the G7 members plus Argentina, Australia, Brazil, China, India, Indonesia, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey and the European Union (EU). The G20 is considered more inclusive than the G7/8, with the countries within the G20 making up about 85 per cent of global gross domestic product (GDP), over 75 per cent of global trade, and 67 per cent of the world’s population.

“The G20 was formed as an extension of the G7 with the aim of having a more diverse group in the field of international governance, acknowledging the rise and influence of other important emerging economies.”

The G20 (like the G7/8) is made up of finance ministers and central bank governors who meet regularly, and leaders who meet once a year to discuss contentious policy and economic issues facing the global economy.³ The G20 presidency or chairmanship rotates annually and the group does not have a permanent secretariat. The G7/8 and the G20 operate concurrently with their own distinct agendas.

The G20 has some clear advantages over the G7/8:

- The G20 is more representative of the global economy and current economic and political powers⁴ – particularly as it includes the BRICS, i.e. Brazil, Russia, India, China and South Africa – meaning that emerging markets play a bigger role in the G20 than they do in the G7/8;
- It is not so big and divided that consensus is too difficult, such as the case of the UN⁵; and
- Its long-term perspective means that it is less likely to get hindered – in theory – by political short-termism, allowing it to include issues that are more contentious on its agenda than those on the G7/8's agenda.⁶

The G20 is often criticised for duplicating the work of other organisations. However, the G20 process is such that it has the ability to work with other international governance groups rather than compete with them. The G20's role is to build consensus and enable cooperation. It can do so by working with other organisations that have the processes in place to enact the reforms the G20 has set.⁷ For example, the work to address tax avoidance, and in particular, base erosion and profit shifting, is being carried out by the Organisation for Economic Co-operation and Development (OECD) as requested by the G20⁸. In this sense, the OECD is a vehicle through which reform is being implemented, with the G20 the engine behind it.

“The G20's role is to build consensus and enable cooperation. It can do so by working with other organisations that have the processes in place to enact the reforms the G20 has set.”

Despite its many advantages, the G20 does have shortcomings. For example, the G20 has limited formal powers, leading to criticisms that it has restricted ability to implement change, and while it can complement other organisations, some duplication does occur. Likewise, the G20 may be more representative of the world economy, but it does not represent everyone and there are still concerns about how inclusive it is, particularly when it comes to smaller developing countries. The G20's reform progress has not been flawless either; it has been slow and uneven in some areas, e.g. shadow banking, while it has yet to address other areas of concern, e.g. the root causes of financial crises.

G20 agenda and Australia's presidency

Many of the major issues plaguing the world today are global in nature and have causes and effects that affect every single country around the globe⁹ – from climate change, to taxation, to the possibility of future global financial crises. As a result, there is a significant role to play for an international organisation such as the G20, which has the weight of much of the global economy behind it, in pushing for international cooperation in matters that require a global economic approach.¹⁰

In 2014, under Australia's presidency, the G20 agenda focuses on growth and resilience with priorities of:

- Anti-corruption;
- Development;
- Employment;
- Energy;
- Financial regulation;
- Fiscal and monetary policy;
- Investment and infrastructure;
- Reforming global institutions;
- Tax; and
- Trade.¹¹

Australia's agenda is praiseworthy in that as it is narrow and focused, cooperation and consensus is more likely.¹²

In February 2014, Australia and the G20 announced an economic growth target of raising G20 GDP by more than two per cent above expected levels over the next five years. While this may not seem revolutionary given that most countries are typically trying to improve growth,¹³ it was accompanied by commitments to produce concrete policies and action plans by every member nation to get results. Through this, Australia is attempting to add a measure of peer pressure for accountability in the G20 process, making it clear that the Brisbane Summit will not be just a 'talkfest'.¹⁴

Australia's presidency also comes with other strengths. Australia is generally respected in international forums, more so in economic forums given its above-average economic performance with more than two decades of uninterrupted economic growth.¹⁵ Australia's location and close ties to Asia is also positive as it can bring understanding of the region to G20 discussions, and is likely to be more inclusive of developing and emerging countries.¹⁶

However, Australia has been widely criticised for dropping climate change from the agenda on the basis that it is not an economic issue. Climate change is a G20 litmus test as well as a test of Australia's role. It is a problem with a global consequence requiring collective action. As such, there is growing pressure to include

climate change on the G20 agenda, particularly following the G7/8 meeting in Brussels in June 2014. At this meeting, the G7/8 leaders called for urgent action on climate change. The United States and China, two countries that are much more powerful than Australia is, are also taking the lead on climate change.¹⁷

Despite the efforts of Australia to exclude climate change from the agenda, it is still likely to be discussed at the Brisbane Summit. This is perhaps a reflection of the limits of Australia's power in the international governance space.¹⁸ As a middle-power economy, Australia's leadership and influence may be limited, as discussed by Professor Mark Beeson in Chapter 1. For example, members may be receptive to Australia introducing new ideas and changing the agenda, but without the support of players who are more powerful, these ideas may not be taken seriously.¹⁹

The climate change issue stresses the importance of getting the G20 agenda right. The G20 has proven successful at issues that require global coordination, and the agenda should continue to focus on policy and economic issues that have global causes and effects. In the case of climate change, it may be argued that it is best left to the G7/8 given their commitment to the topic²⁰, or to the more globally representative UN. However, there is still a role for the G20 to play in addressing climate change. The G20's role would not be to come to a global climate action agreement or decision, but rather to engage in open discussions that may not be possible at other global organisations such as the UN.²¹

In June 2014, CEDA released its climate change policy perspective, *The Economics of Climate Change*, which examines the economic consequences of failing to take any action in regard to climate change, and considers what policies will be most effective for Australia to mitigate and adapt to the effects of climate change. G20's value-add to the global debate could potentially be discussions on the economic risks and consequences of climate change. The economic angle would be in keeping with the narrow economic focus of the Brisbane Summit.

G20 climate change discussions would be more representative of the global economy than G7/8 discussions. The information gained from the G20 discussions would not be without value, as it would help to inform global policy development, adding its members' political weight to climate action negotiations that may be happening at other forums.²² This includes the potential for the G20 to inform the 2015 United Nations Framework Convention on Climate Change (UNFCCC) Conference of the Parties (COP 21) in Paris.²³

G20's reform record

The G20 has been almost unanimously credited with saving the world from the GFC given how instrumental it was in garnering global economic cooperation to mitigate the effects of the crisis, particularly in terms of regulatory reform of the finance sector, economic stimuli and debt reduction.²⁴ For example, the G20 used the International Monetary Fund (IMF) as a vehicle to inject money into the

global economy and created the Financial Stability Board (FSB) – as successor of the Financial Stability Forum – to provide better regulatory oversight of the international financial system.²⁵

Specifically, the G20 identified the following areas for reform during the GFC:

- Stronger prudential standards;
- Addressing too big to fail (TBTF) financial institutions;
- Reforming over-the-counter (OTC) derivatives; and
- Reforming shadow banks, i.e. financial institutions that act like banks but are not banks and therefore not subject to the same oversight.²⁶

These reforms are ongoing and expected to be completed in the next few years, with varying degrees of success. Basel III, an example of stronger prudential standards, is being hailed a success, while reforms to address TBTF institutions have not been implemented satisfactorily. Implementation of the last two reforms has been weak and uneven across countries.²⁷ There is still much work to be done.

The result of the financial reforms can be broadly summarised as having improved financial stability through better bank regulation, lowering the risk of bank failures under normal circumstances, and through reduced cost of bank failures if they occur under abnormal circumstances.²⁸ While the current reforms are commendable, they do not necessarily address the root causes of financial crises, particularly the GFC. They also fail to address the new problems that have arisen since the GFC, as Dr John Edwards discusses in Chapter 2.²⁹ Again, there is room for improvement when it comes to global financial system reform.

Beyond the crisis, the G20 has continued to work with its members and other organisations such as the IMF to support global financial cooperation, e.g. in the ongoing Eurozone crisis.³⁰ One other area in which the G20 has continued to be influential is taxation. As Professor Kerrie Sadiq explains in Chapter 3, international taxation reform is firmly on the G20 radar, with clear commitments to address tax avoidance, promote international tax transparency and global information sharing, and include developing countries in the agenda.³¹

The most notorious form of tax avoidance is base erosion and profit shifting (BEPS). BEPS occurs when companies, typically large multinationals, use loopholes such as profit shifting to avoid paying tax or to reduce the amount of tax they pay. BEPS means that countries are unable to tax entities at the location where the economic activity takes place. This makes it unfair for those governments missing out on tax revenue.³² The G20 has been proactive in discussing potential reforms, although no agreement is in sight.³³

When it comes to tax transparency, the G20 has been quite successful at addressing automatic exchange of information (i.e. exchange of information between taxing authorities) while more work is still required when it comes to mandated taxation disclosure. Similarly, the G20 has been more inclusive when it comes to developing nations to ensure that their concerns are addressed in the taxation reform arena. The task, however, is by no means complete.³⁴

Securing G20's future

One thing is clear from this analysis of G20's record in reforming the international financial system and taxation regulation: There is still much work remaining to be done. As host of the G20, Australia cannot be complacent about the need to lead further initiatives and reforms in those areas. Australia should ensure that the G20 is seen as a constructive and sustainable force in the international governance space by addressing the current weaknesses in the global financial system and taxation reforms, and putting forward new reform agendas. In particular, this policy perspective proposes reforms in BEPS, mandated taxpayer disclosure, inclusiveness and financial regulation.

BEPS: Tax avoidance, and in particular, BEPS, occurs because the international taxation regime is outdated and does not take into account current globalisation realities and trends. Although the G20/OECD is addressing BEPS, progress so far has been confined to acceptance of the problem and discussion of reform. The plan currently aims to address flaws in the current tax regime but to properly address BEPS, Australia and G20/OECD should consider the possibility of changing the current tax regime to move away from the traditional models of taxation that are still being used.³⁵

Mandated taxpayer disclosure: The G20 agenda is not clear when it comes to country-by-country reporting and may be too narrow. There is scope for Australia to address this concern by being inclusive in seeking feedback and adopting a wider approach to taxation reporting reform. In particular, the reform should ensure that the regulatory authority is more than just a reporting regime for taxation authorities. It should also enable the regulator to inform the public on the activities of multinationals to promote transparency in the system.³⁶ At the moment, the G20 is not considering this.

Inclusiveness: Any taxation reform agenda must take into account the impact of reform on developing countries due to their lack of representation at international governance forums. The G20 has a role to play to lead a best practice/benchmark of seeking feedback from emerging nations when developing taxation policies. Australia also has a role to play in ensuring the process is more inclusive thanks to its close ties to developing nations in South-East Asia.³⁷

Financial regulation: The existing reforms were not intended to prevent future crises from happening; instead, they were intended to improve financial stability and mitigate the impact of the GFC. Given the likelihood of future crises occurring, Australia and the G20 cannot become complacent about the current financial system and the reforms that have been achieved so far. The agenda should go beyond completing current reforms to include policies that address

“Australia and the G20 cannot become complacent about the current financial system and the reforms that have been achieved so far. The agenda should go beyond completing current reforms to include policies that address the demands of the continued globalisation of financial systems, the root causes of the GFC and new issues that have arisen since, with a view to reducing the risk of future crises occurring.”

the demands of the continued globalisation of financial systems, the root causes of the GFC and new issues that have arisen since, with a view to reducing the risk of future crises occurring. For example, it should ensure that regulatory oversight authorities continue to examine financial institutions intrusively and extend their powers to include institutions that are not properly supervised, e.g. shadow banks. The agenda should also include specific action on shadow banking, one of the causes of the GFC, in particular.³⁸

Conclusion

Australia's presidency of the 2014 G20 is a challenging one. Australia has a big job to do to keep the G20 on course as a relevant international governance institution, in spite of criticisms that the G20 is turning into a 'talkfest' and the lack of any crises. Australia's role will not be easy, and as a middle-power nation, its influence in international forums may be limited. However, Australia does have the potential to be an effective leader at the G20, particularly given its close ties to the emerging economies of Asia and the respect afforded by other G20 members, especially on economic matters.

Despite the commendable role the G20 has played so far in reforming the international financial system and taxation regulation, the job of the G20 is not yet done and there is a need for further reforms in both areas. At the November 2014 Brisbane Summit, Australia cannot be complacent about what the G20 has achieved so far. It can and should play a leadership role in ensuring that the G20's role remains relevant, sustainable and influential in the fields of taxation and regulation by going beyond the past agenda to a new reform agenda, while adding political weight to other contentious global issues such as climate change.

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1. Can the G20 ever realise its potential?

Professor Mark Beeson

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This chapter explores the potential and the limitations of the G20, and discusses Australia's role in the G20 Summit in Brisbane.

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Introduction

The G20 Summit in Brisbane has the potential to address the chronic 'legitimacy deficit' that has plagued supranational institutions since they became a prominent part of the global institutional architecture.¹ Such institutions have been around for a surprisingly long time, yet they have often failed to realise the hopes of their participants. Nevertheless, there are a growing number of such international organisations that have been established to try to facilitate international cooperation and to address the numerous problems that seem to require collective action.

And yet, solutions to pressing global problems such as climate change seem as elusive as ever. While environmental problems are unprecedented in their scale and complexity, effective international cooperation remains difficult and rare, even in more familiar and comparatively less fraught fields.

Some of the main reasons that institutionalised responses to international problems remain challenging are that the organisations are:

- So large that consensus is all but impossible, such as the United Nations;
- So small that they are seen as unrepresentative, such as the BRICS, i.e. group of emerging economies of Brazil, Russia, India, China and South Africa; or
- Representative of an increasingly discredited global elite, such as G7 and G8.

The G7 and G8 only represent a fraction of the world's population, and an unrepresentatively over-privileged one at that. They do not even contain China, a country that would seem to demand inclusion in any economic, strategic or environmental grouping in the contemporary era. This may not have stopped the G7 or even the G8 from agreeing on particular initiatives or policies at times, but they could hardly claim to be representative of global public opinion — even supposing such a thing exists. The potential strength of the G20 is its claim to represent some of the most significant rising powers, not to mention some of the most populous ones.

The G20 is a product of specific historical contexts. Its ability to act is both facilitated and constrained by unique and evolving circumstances. It is worth reminding ourselves of the way these can change and affect the capacity of inter-governmental organisations like the G20 to act if we want to understand the limits and potential of 'global governance'.²

The evolution of global governance

'Globalisation' is useful shorthand for an array of interconnected economic, political and social processes that have transformed the modern world.

Before World War I, economic integration, as measured by trade and capital flows, had reached levels that would not be seen again until the 1970s.³

Two world wars and the Great Depression are reminders that there is nothing inevitable about global integration, or even 'progress'. Globalisation can go backwards as well as forwards.

If it is to continue, globalisation requires:

- Political will;
- Cooperation; and
- A facilitating institutional architecture.⁴

Russia's current exclusion from the G8 shows how rapidly changing geopolitical realities can change the shape and effectiveness of seemingly established pieces of international institutional architecture.

The great achievement of the Bretton Woods System, established in 1944, was the creation of an environment in which trade liberalisation could be facilitated. Significantly, however, there was much less enthusiasm about freeing up the finance sector. Many think it is no coincidence that this period coincided with a 'golden age' of economic development that was strikingly stable compared with the crisis-prone past.⁵

The priorities and principles that underpinned the Bretton Woods System were neither inevitable nor arbitrary. The decision to encourage trade integration through sustained tariff reductions on one hand, and the creation of a system of managed exchange rates on the other, reflected an intense process of intellectual

and political contestation in which a specific economic regime was thrashed out.⁶ Geopolitics was at least as important as any debate about the technical merits of one policy over another.

Not only was the United States revealed to be the most powerful country on the planet following World War II, but it was intent on securing the ‘free world’ from the threat of communist expansion. The Soviet Union, it should be remembered, was a credible rival. Many thought capitalism might not prevail let alone go on to become essentially the only economic system in the world.

While there may be many varieties of capitalism in the contemporary global economy,⁷ there is, to paraphrase Margaret Thatcher, no alternative to capitalism itself. The big debates these days revolve around technical discussions about the best way to manage capitalist economies, not about whether they should exist.

In such circumstances, the potential leverage that the reigning ‘hegemonic’ power of the day can exercise is diminished.⁸ One of the reasons the United States was able to exert such an influence over the creation of the post-war international order and the operating principles and norms it enshrined was not simply because it accounted for 30 per cent of global gross domestic product (GDP) and the most powerful military in the world. Clearly such material attributes underpinned American authority, but it is equally evident that much of its influence was ideational. Many subordinate states believed that American leadership was beneficial and that an open liberal economic order was desirable – especially compared with the Soviet alternative. In such circumstances, it was much easier for the United States to achieve its interests with relatively little resistance.⁹ Now things look rather different.

The decline of the West and rise of the rest

Structural changes in the international political economy have altered the way in which international institutions operate and the goals they pursue. For example, the International Monetary Fund’s (IMF) role has evolved from overseeing a system of fixed exchange rates to an international crisis manager. The change is no coincidence but directly related to underlying changes in the international economy.¹⁰

It is not simply the fact that some key organisations such as the IMF and the World Trade Organization (WTO) have changed that is so striking; it is that the international economy itself is a far more integrated arena. As a result, the balance of economic power has shifted dramatically. Some of the most important manifestations of this transformation are ‘communist’ China’s accession to the WTO and Chinese officials’ more prominent and active roles in some of the formerly Western-dominated international financial institutions.¹¹ For instance, the appointment of a prominent Chinese economist, Justin Yifu Lin, as the Chief Economist at the World Bank.

Lin is a prominent advocate of East-Asian-style state interventionism. Indeed, he thinks that China's and other East-Asian economies' experiences ought to provoke a rethink of the way we understand the roles of the state, the market, and other institutions in a developing country's process of development and transition as they attempt to catch up with industrialised nations.¹²

China's growing material importance to the global economy means that it will inevitably influence the institutions that attempt to govern international economic activity. China's rise may herald a new set of ideas, influences, interests and operating principles in arenas that the West has formerly dominated. The key question is whether China's ruling elites will be 'socialised' into the norms and practices of the largely Western-dominated international order, as some believe,¹³ or whether they are likely to want to change the guiding principles of the international institutional architecture to reflect their own ideas and interests.¹⁴

Even before the Global Financial Crisis (GFC), it was clear there were other ways to think about how to manage the international economic system. At moments of crisis, differences tend disappear and collective interests predominate as all are galvanised by similar imperatives. Indeed, the entire Cold War period can be seen — to some extent, at least — as a systemic crisis, albeit of the slow-burning, ideological variety. During such moments of crisis, major institutional change is possible, as powerful states can actively create new international orders.¹⁵

It is no coincidence that what looks like the G20's finest hour thus far came at the height of the GFC when the stability of the entire economic order teetered in the balance. No less an authority than Christine Lagarde, Managing Director of the IMF, thought the world faced the gravest economic crisis since the Great Depression.¹⁶ In such perilous and pressing circumstances, differences were put aside and effective cooperation was – for a moment, at least – actually achievable.

In the aftermath of the GFC, however, one thing became clear: The kind of cooperation that moments of crisis generate may not endure once the immediate danger appears to have passed.¹⁷ As the collective will and reformist momentum that characterised the early crisis-management period rapidly dissipated, earlier national differences and divisions re-emerged.¹⁸ Such divisions were manifest in the all-too-predictable renaissance of the same powerful vested interests that were primarily responsible for the crisis in the first place.

As former Chief Economist of the IMF, Simon Johnson notes, "A whole generation of policy makers has been mesmerised by Wall Street, always and utterly convinced that whatever the banks said was true."¹⁹

Despite Wall Street's and 'the City of London's' destabilising role in promoting the sort of regulatory changes that were central to the GFC's emergence, the US and British governments rapidly moved to protect rather than punish their finance sectors.²⁰

"It is no coincidence that what looks like the G20's finest hour thus far came at the height of the GFC when the stability of the entire economic order teetered in the balance."

If these sorts of parochial policies were a depressingly familiar expression of the obstacles to international cooperation, other aspects of the post-GFC world were novel, and reflections of major structural and ideational change. The intellectual foundations of the old order were challenged as they had not been before. To be sure, the Soviets had offered an alternative, but it was systemic rather than varietal. The rise of the so-called BRICS economies generally, and of China in particular, suggested that not only were there different ways of running a capitalist economy, but there may be better ways — especially for those countries still struggling to carve out a developmental niche in a global economy hitherto dominated by the West. In this context, it became fashionable to talk about the ‘Beijing consensus’ rather than its formerly dominant counterpart from Washington.²¹

“The rise of the so-called BRICS economies generally, and of China in particular, suggested that not only were there different ways of running a capitalist economy, but there may be better ways.”

Many scholars reject the idea that there is any coherent Chinese model of development that can be replicated by other states,²² but it is clear that China’s form of ‘state capitalism’ has its admirers – not least because it is unaccompanied by the reformist conditions and strictures that notoriously accompanied the American alternative that the international financial institutions so assiduously promoted.²³

The emergence of new models of economic development and management are tied to very distinctive forms of political power.²⁴ The so-called ‘developmental state’ pioneered in East Asia is synonymous with very different patterns of state-government relations than those that, rhetorically at least, pertain in much of the West.²⁵ Likewise, the sort of patronage politics that underpinned the rise of Russia’s oligarchs is predicated on a distinctive political order that manifests in specific economic policies seeking to protect privileged access to rent-seeking activities.²⁶

International cooperation in non-crisis conditions faces potential institutionalised opposition from powerful vested interests that seek to shape – or deflect – policies that protect the status quo from which they benefit. This has been a particular problem for the G20 as it struggles to represent a broader array of interests.²⁷ This presents an especially difficult challenge for Australia as it seeks to make the most of its period as chair of the Brisbane Summit.

The limits of middle-power diplomacy

Despite the Coalition's longstanding scepticism about the merits and effectiveness of multilateral organisations, like its Labor predecessors, the Abbott Government has demonstrated great enthusiasm about the G20's potential. This is not altogether surprising given there aren't many significant international organisations in which Australia has a place, let alone such a prominent one.

Is this enthusiasm justified? Can the G20 come up with a worthwhile agenda or actually influence its members? To judge from the G20's record generally, and from Australia's presidency in particular, the answer to both questions is not promising and tells us much about the constraints facing effective transnational governance.

Australia's 'big idea' for its period at the G20's helm is encouraging economic growth. As initiatives go, it has the merit of being entirely unobjectionable, but it is unlikely to change the behaviour of the group's members. Which G20 member is *not* trying to boost economic growth, with or without the encouragement of the Australian Government?

More usefully, the G20 could develop strategies that might allow more synchronised and coordinated policies to be enacted through the auspices of their increasingly influential central banks.

Such actions would necessitate developing some sense of collective purpose and common interest. Unfortunately, large organisations risk succumbing to the politics of the lowest common denominator. Without a compelling reason to change, powerful vested interests at the national level are likely to exert more influence than their transnational equivalents.²⁸ Indeed, one of the more noteworthy features of evolving patterns of global governance is the way private-sector interests have bypassed national governments to establish regulatory networks in a host of areas that were formerly the preserve of individual states.²⁹

Another feature of global governance that raises questions about the impact and effectiveness of states is the increasingly influential role of like-minded technocrats, such as central bankers, who have been granted a good deal of autonomy by states themselves.³⁰ Whatever the technical merits of such initiatives, they are another telling example of the challenges that governments everywhere face when trying to develop and enact effective national policy, let alone coordinate with their peers who may be responding to different pressures and incentives.

States like Australia face a dual challenge: Not only do they have to deal with the sort of ubiquitous pressures that states everywhere face as their authority and competence is challenged by novel external developments, they must also contend with the continuing pressures from powerful internal forces – and not just from their economic and political elites. The continuing salience of, and

“Australia's 'big idea' for its period at the G20's helm is encouraging economic growth. As initiatives go, it has the merit of being entirely unobjectionable, but it is unlikely to change the behaviour of the group's members.”

differences within, national varieties of capitalism means that agreement on common reforms and initiatives remains difficult. There simply is no unambiguous, self-evident ‘best practice’ on which all can agree.

Any regulatory reform inevitably creates winners and losers. Countries at different levels of development with different forms of political economy will inevitably prefer regulatory frameworks that suit their particular conditions. In such circumstances, history suggests that the most powerful states will have the biggest influence in determining what can and cannot be done. This is worth keeping in mind when thinking about what the G20 can achieve and what influence Australia can exert.

Australia is a modestly credentialed ‘middle power’ with some undoubted capabilities as a broker of new ideas, but one that faces formidable capacity constraints when trying to get others to take such ideas seriously. Even at moments of crisis, there were plainly limits to what a state such as Australia could do without the support of more-powerful players.³¹

It is revealing that the G20 has not been able to build on its initial response to the GFC and develop an effective regime to either make future crises less likely, or to deal with the currency wars and global imbalances that have built up in the wake of the GFC.³²

The G20's prospects

None of the foregoing is meant to suggest that the G20 is a waste of time or that Australian policymakers should not be attempting to make the most of the possibilities it opens up. However, it is important not to be too starry-eyed about its prospects. Effective international cooperation is an unrealised work in progress at best, and an unrealisable pipe dream at worst. The fact that Australian Treasurer, Joe Hockey, has even suggested that the G20 should push on with its international reform agenda without a politically gridlocked United States is indicative of the difficulty in achieving broad cooperation.³³

One of the most critical challenges facing the G20 will be deciding where it can make a difference. The temptation will be for all members to push their preferred agendas while they have the attention of other world leaders. The danger is that the G20 becomes unfocused and tries to do too much – duplicating the efforts of other institutions and actors. Yet even if it remains focused on economic issues where it has demonstrated capacity to make a difference at moments of crisis, the G20 still faces the formidable difficulty of overcoming vested interests and national differences in these relatively stable times.

While institutions of global governance proliferate, their ability to address critical challenges – much less solve them – hasn’t necessarily increased. Overlapping jurisdictions, competing authorities and the sheer difficulty of eliminating existing institutions that are either ineffective or have passed their use-by-date are plainly part of the problem. Fewer organisations with clearer, focused agendas could

make cooperation more effective and likely. Achieving political agreement and the determination to make difficult decisions will, of course, be equally important.

In this context, the recent meeting between Tony Abbott and Barack Obama was significant and revealing. President Obama is clearly beginning to think about his ‘legacy’ and seems determined to try to do something about climate change. He has already undertaken actions that could have a major impact on the coal industry in the United States. Now Obama wants to use the G20 to pursue a wider international agreement. His host is determined to maintain a narrower focus on economic issues that are likely to prove less contentious, more feasible, and in keeping with the G20’s original agenda.³⁴

While Abbott’s preferred agenda may be a welcome recognition of the over-burdened nature of the G20’s existing ‘to do’ list, it is also a reminder of the scale of the problems facing humanity – and the role that ideological preferences can play in prioritising individual countries’ responses to them.³⁵ By keeping the focus on economics rather than more-ambitious forms of international cooperation, Australia may exercise some modest leadership. Whether this is the direction this country or any other ought to be heading is another story, and not one that the G20 is likely to resolve.

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2. Unfinished agenda: The Brisbane G20 Summit and global financial reform

Dr John Edwards

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This chapter explores the global financial reform agenda that began after the Global Financial Crisis, and considers how this agenda may progress during the G20 Summit in Brisbane.

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Introduction

Over the six years since the Global Financial Crisis (GFC) dramatically exposed the fragility of the global financial system, a formidable agenda of financial reform has been undertaken. November's G20 Summit in Brisbane is scheduled to "substantially complete"¹ this reform agenda.

The status of the global financial reform debate is particularly pertinent for Australia as it chairs the Brisbane Summit and manages the agenda.

Many of the reforms initiated six years ago have been completed, while others are sufficiently advanced to reach completion soon. The reforms have been at the global level, and more importantly, at the national and regional level – particularly for the vortices of the GFC, the financial systems of the United States (US), the United Kingdom (UK), and the European Economic and Monetary Union.

The accomplishment of a good deal of the reform agenda is all the more remarkable because it has been contemporaneous with the decline of most other forms of international economic cooperation. For instance, a global agreement in the Doha Round of trade negotiations remains distant; negotiations over the restructuring of the IMF to accommodate the changing balance of global economic weight have stalled; and after a strong start in 2008, the G20 has been unable to replicate even the meagre capacity for global macroeconomic governance sometimes attained by the G7.

Despite continuously increasing global economic integration, international economic cooperation has withered – except in this one pre-eminently important and abidingly global realm of finance. (And even in that realm, the extent of global coordination is qualified. As the March 2014 IMF paper argues, “Coordination improved during the early days of the crisis but had largely lapsed since... Financial regulation and supervision remain largely national.”²⁾

While much has been achieved, what *has* been achieved – particularly in new global rules – is mostly in the regulation of banks, and mostly in enhancing the structure of earlier bank regulation. The effect is to reduce the likelihood of bank failures in ordinary circumstances, and reduce the cost to governments and taxpayers of bank failures in more extreme circumstances. These changes, some already effected and more scheduled to take effect by 2019, increase the quality and appropriateness of bank capital and therefore the buffer against loss, or they provide for the wind up of loss-making institutions without cost to national central banks and finance ministries.

Some of the pending or effected reforms do reduce the risk of future crises. These reforms include new liquidity requirements; an overall leverage ratio; and in the US, UK and Europe, new rules to limit financial market speculation by banks. Despite this, the risk of financial crises remains because the basic and recurrent cause of crises remains: The maturity mismatch between the assets and liabilities of financial intermediaries and the associated difficulty of realising assets values during financial panics induced by the threat of failure. Though future financial crises may cost governments less, their economic impact could still be devastating.

While great progress has been made in addressing some of the issues that the GFC raised, new issues have since arisen. Some of these issues are the result of the measures adopted by policy governments and central banks to recover from the GFC. For instance, in Europe, the sharp rise in sovereign debt following the GFC forced the European Central Bank (ECB) and European Union (EU) finance ministers to extend the regulatory and support roles of common currency institutions, including the ECB. Those changes are still far from complete, as is the restoration of market confidence in the loss provisioning of European banks.

In Japan, the US and Europe, the central bank policy interest rate remains at, or near, zero – in the European case, a little below. The willingness of investors to increase risk with the aim of increasing yield in the face of low rates on secure debt caused a considerable rise in junk bond prices and holdings in global markets. At the same time, the greater availability of US-dollar loans and low yields caused swift increases in cross-border transactions involving higher yield emerging-economy assets, some of which are less transparent and less liquid than the markets from which the corresponding liability is drawn.

The reform agenda has also introduced a largely unspoken uncertainty into the market in seeking to better protect government from loss, which may encourage crises. If markets, for example, are convinced that central banks will no longer come to the rescue of failing institutions – and this is sometimes the message communicated by national authorities – the sensitivity of lenders to the possible

failure of an institution will likely be all the more acute. The Australian Prudential Regulatory Authority (APRA), for example, has publicly refused to support changes that might imply a willingness to support failing banks³. By contrast, Reserve Bank of Australia (RBA) Governor, Glenn Stevens, affirmed that there may be circumstances in which the regulator's responsibility for the economy as a whole would demand intervention⁴.

An active and widely respected contributor to the global financial reform agenda, Australia is well represented on the various committees advancing finance sector reform. For three years, the now head of APRA, Wayne Byres, was the secretary general of the Bank of International Settlement's Basel Committee on Banking Supervision (BCBS). The BCBS is the key group devising the banking capital and liquidity reforms known as Basel III. However, Australia was not invited to join the European-dominated BCBS until the committee was broadened in 2009, and it is not a member of the informal inner group. Australia has never chaired the Financial Stability Board (FSB), the key institution mandated by the G20 to advance the reform agenda, or the BCBS. In global financial reform, Australia has been closely engaged but not been a leader. Until the end of the Brisbane Summit, however, Australia must necessarily play a more prominent leadership role in shaping the financial reform agenda. Australia therefore bears some extra responsibility for the quality and unanimity of the outcomes.

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This responsibility is not merely honorific because the pending completion of much of the financial reform agenda set in 2008 poses for the Brisbane Summit a choice between two quite different directions.

First, Australia can, as Glenn Stevens has argued, look for “careful and sustained efforts at implementation of the regulatory reforms that have already been agreed,” while, “being wary of adding further reforms to the work program”⁵. The whole reform agenda should, in this view, now focus on actually implementing agreed reforms rather than continuing to work on new reforms.

The alternative view is that most of what has been achieved in the past six years is in the regulation of banks, particularly in the Basel III agreement, and the pattern of regulation is tougher but much the same in principle as prior to the GFC. This does not address the risks that became apparent in the GFC, or the risks that have become more apparent since then, particularly those presented by the operation of financial markets and non-bank intermediaries.

International Monetary Fund (IMF) Managing Director, Christine Lagarde, told a London conference in May 2014⁶ that progress on reform had been too slow and that the finance sector had “not changed fundamentally in a number of dimensions since the crisis”. Her remarks followed a major paper⁷ in March 2014 in which two IMF finance reform experts argued that “several years beyond the height of the crisis, the financial reform agenda is still only half-baked at best.”⁸

What caused the Global Financial Crisis?

A widespread interpretation of the Global Financial Crisis (GFC) is that while finance sector failures were the proximate cause, its ultimate cause was some combination of loose monetary policy, fecklessness among American consumers, a house price bubble, and a global 'savings glut' primarily due to China, Japan and the Middle East saving too much and investing too little. In this interpretation, major financial institutions like Lehman Brothers were the victims of the GFC rather than its cause. Accordingly, one might argue, the emphasis on global financial reform is misplaced.

While this interpretation is commonly accepted, it does not seem to square with the facts. For example, a striking fact of the five years to 2008 is that in most countries, monetary policy was tightening. This was particularly true for the US, the UK, Australia and Canada. The laggard in tightening was the European Central Bank (ECB), which did not begin to raise rates until the end of 2005. In addition, long-term market rates were rising in the US, Japan, Germany, the UK and Australia. Long-term market rates did not increase by a large amount, but they did increase.

This interest rate pattern complicates the 'imbalances' and 'savings glut' stories. Rising interest rates suggests that intended investment exceeded intended saving. That would be consistent with the fact that the US dollar steadily declined over the period. The US dollar depreciated on average from the beginning of the decade. Even the Chinese Renminbi appreciated 12.5 per cent over the US dollar from 2003 to 2007. If intended global saving exceeded intended investment, and the US was a favoured place for investment, the US dollar would have appreciated as savers competed to buy US assets. The US dollar's depreciation suggests that if there was anything going on at all through imbalances, then intended investment exceeded intended saving, or alternatively put, intended current account deficits exceeded intended surpluses.

Interpreted this way, there was not a savings glut but a savings shortage, or at least that would be more consistent with the observed facts of rising interest rates, the decline of the US dollar, and the persistence of a very strong global expansion. I doubt imbalances played much of a role in the GFC at all. Net financial flows into the US, after all, merely balance the outflows. The net capital inflow is equal to the current account deficit, which is the sum of the trade deficit and net income from abroad. For example, China's purchase of US-government bonds allows the US to pay for China's goods exports to the US.

Nor is the story about excessive US consumption entirely convincing. Asset prices, or at least the price of houses and financial assets, did rise in many countries. However, in many respects the period was also one of reasonably balanced growth. It's true that US home building (or residential investment) increased 35 per cent from the beginning of the decade to the first quarter of 2006 (which was close to the peak). Over six years, however, this is not a huge increase. Australian home building by contrast rose at twice the pace (64 per cent) in the boom years from the end of 2000 to the beginning of 2004. Similarly, consumption growth in the US was not excessive in the five years leading up

to the crisis. Looking at the period from the first quarter of 2003 to the first quarter of 2008, US consumption increased at exactly the same rate as GDP, which over the period was 15 per cent. At an annual average growth rate of less than three per cent, this is hardly a boom. With growth of 40 per cent over the period, business investment rose far faster than GDP. Exports did even better, up 50 per cent. The real story in the US in those five years before the crash is that exports and businesses investment did rather better than consumption and home building, but that overall GDP growth was quite modest.

The relationship between global 'imbalances' and 'liquidity' is not at all clear. Foreign capital inflows do not change the money supply in the US, since it has a floating exchange rate. Prior to 2008, it was widely said that imbalances explained liquidity. In the two years thereafter, liquidity vanished. Lending growth and leverage plummeted, yet the imbalances, or the global pattern of current account surpluses and deficits, were not much changed, interest rates were much lower, and central banks everywhere provided bank reserves on a grand scale. Evidently, 'liquidity' and leverage are largely self-generated phenomenon, or as economists would say, are "endogenous".

If the real cause of the GFC was the fecklessness of American consumers, or US government pressure on lenders to encourage loans to borrowers unlikely to repay, or otherwise astute bankers led astray by 'the search for yield', or a global 'savings glut', then the attention to financial market reform has been entirely the wrong emphasis.

The debate over the causes of the GFC continues, but it is quite difficult to discover any serious view that the regulatory rules governing financial markets and financial institutions were not in need of serious reform.

The agenda emerging from the GFC

The US financial crisis that developed through 2007 and into 2008 became a global economic calamity. The collapse of the investment bank Lehman Brothers in September 2008 effectively froze lending between major financial institutions that were unclear about the soundness of their counterparties. This was the most serious element of the crisis, and it required major intervention by central banks and political leaders to restart a locked global financial system.

For all the apparent novelty, it was in many respects a classic financial crisis caused by a widespread loss of confidence in the funding base of financial institutions with illiquid assets and no backstop. In this case, the illiquid assets were

financial instruments that bundled home mortgages (or derivatives based on them). As confidence deteriorated, these instruments proved hard to value and therefore impossible to sell. The funding base for the institutions' holding these assets was often provided by money market mutual funds, lending overnight.

Several aspects of this experience informed the regulatory agenda. The first was that the derivative assets, usually collateralised debt obligations, were in the US either not regulated at all or regulated only lightly, and they proved far more risky than ratings agencies or the vendors claimed. Something needed to be done about these complicated financial assets, especially since they were usually traded between financial institutions ('over the counter') rather than on open exchanges.

The second was that the initial failures were largely in unregulated institutions, 'shadow banks' that had no access to lender of the last resort facilities. Shadow banks are institutions that may engage in maturity or liquidity transformation, are part of the financial system, and are connected with banks through financial transactions. However, they are not regulated like banks. Though unregulated, they posed threats to the stability of the entire system and to the stability of banks in particular, since they all borrowed from and lent to each other. Another agenda item, therefore, had to be to extend a regulatory scrutiny to shadow banking that was far more intrusive, and to make them less likely to fail.

“Troubles spread very quickly to regulated institutions. A crisis of liquidity as they met withdrawals threatened to turn into a solvency crisis as their capital, the buffer between assets and liabilities, was ground down. Authorities in the US, the UK and Europe had no choice but to support these regulated institutions, which proved expensive.”

The third was that troubles spread very quickly to regulated institutions. A crisis of liquidity as they met withdrawals threatened to turn into a solvency crisis as their capital, the buffer between assets and liabilities, was ground down. Authorities in the US, the UK and Europe had no choice but to support these regulated institutions, which proved expensive. Part of the reform agenda – as it turned out, the most important part – was therefore to mitigate the cost to governments of finance sector failures.

Meeting in November 2008 amid the global panic and at heads-of-government level for the first time in the institution's history, G20 leaders adopted principles for finance sector reform and tasked the BCBS of the Bank of International Settlements (BIS), the Financial Stability Board (recreated from the then Financial Stability Forum, established in response to the 1997 Asia financial crisis), and the IMF to develop policies and plan their implementation.

At the same time, national authorities were spurred to devise reforms, some of which linked easily to the global agenda, and some of which were unique to the political, legal and market arrangements of the particular country. The US and the UK in particular needed to move swiftly on national reform, and the EU soon discovered its challenge was no less pressing.

Four major areas of reform identified at the November 2008 G20 meeting were:

1. Strengthening prudential standards to reduce the riskiness of financial institutions. The major objective was what became known as the Basel III reforms. These reforms increase bank capital-to-assets ratios, redefine acceptable forms of capital, and add a constraint on overall leverage unweighted for risk. The program also includes a liquidity coverage ratio requiring banks to hold sufficient liquid assets to withstand 30 days of funding stress. In principle, the program included provision for increased capital during periods of rapid asset price inflation and credit growth, though no global prescription for this 'counter cyclical buffer' is likely.
2. Addressing the problem of institutions so large and so interrelated with other elements in the financial system that they are 'too big to fail' (TBTF), and need to be bailed out by the taxpayers. The focus here has been on identifying globally significant banks to be subject to greater regulatory scrutiny and higher capital requirements. There is a companion regime for a second tier of large banks systemically important to the economy in which they are based, though not to the global system.
3. Reforming the over-the-counter (OTC) derivatives market. These are private transactions between financial institutions rather than open transactions in markets in which prices and quantities are visible to all participants. The lack of transparency in OTC transactions reduces the liquidity of these instruments and increases their price volatility in crises. To reduce these risks – startlingly apparent during the GFC – the objective is to move more derivative transactions onto open markets, and to introduce higher capital charges and collateralisation where trades are not centrally cleared.
4. Reducing the risks arising from shadow banks. Shadow banks are institutions that are not regulated as banks, but engage in credit intermediation or maturity and liquidity transformations. The September 2013 Summit agreed on some proposals to control shadow banking.

There is now much else besides these four major objectives in the reform project. As the RBA's Carl Schwartz⁹ notes, these four major objectives now account for barely half of the 39 work streams covered in a report by the FSB to the September 2013 G20 Summit. However, these four areas remain the major strands of reform.

Adopting and implementing the reform measures

The FSB reports progressively on the advancement of the reform agenda. In its most recent report to the September 2013 G20 Summit, the FSB assessed that global policy development was well advanced in most of the areas of its agenda, though implementation of agreed changes by national governments was markedly slower.

The parts of the agenda most advanced are those that enhance regulatory rules already in place before 2008, notably the development of Basel III rules on the base of Basel I and Basel II. (Basel II was coming into force just as the GFC hit. It was an amendment to the Basel I rules.) These rules are developed by what is now the BCBS, which had its origins as an American and European group of banking supervisors responding to banking collapses in the early 1970s. Its focus was then on the adequacy and form of bank capital, which is the gap between its liabilities to its lenders and its assets in the form of, for example, loans and trading securities. The BCBS focus has largely remained on bank capital.

National jurisdictions have long imposed requirements, but global regulation is relatively recent¹⁰. It was not until 1988 that the Basel Capital Accord (Basel I) was agreed upon. It called for a minimum of eight per cent of capital to risk-weighted assets to be implemented by the end of 1992. The accord was amended from time to time, including extending capital requirements to bank exposures to tradeable assets like debt securities, equities and foreign exchange. The entire framework was updated to increase transparency, adjust risk weighting and permit banks to choose to measure their own risk positions. Basic capital requirements remained much the same as in the earlier accord. In many respects, Basel II, with its encouragement of a bigger role for ratings agencies and bank risk assessment based on their internal models, was the high watermark of confidence that a lighter regulatory touch would suffice. The collated text of the accord was released in June 2006 and was only just being adopted as Lehman Brothers collapsed in September 2008.

“National jurisdictions have long imposed requirements, but global regulation is relatively recent. It was not until 1988 that the Basel Capital Accord (Basel I) was agreed upon. It called for a minimum of eight per cent of capital to risk-weighted assets to be implemented by the end of 1992.”

As the BCBS readily concedes, despite Basel I and the many amendments after its adoption, the banking sector “entered the crisis with too much leverage and inadequate liquidity buffers. These defects were accompanied by poor governance and risk management, as well as inappropriate incentive structures. The combination of these factors was manifest in the mispricing of credit and liquidity risk, and excess credit growth.”¹¹ (One might add that Lehman Brothers was not a bank and not covered by the US version of the Basel rules, though it was subject to a rule imposed by the Securities and Exchange Commission – liberalised four years before the crisis – which imposed a capital requirement of sorts.)

Basel III was issued in late 2010 in response to the lessons learned from the GFC. It retains the basic requirement of eight per cent of capital to risk-weighted assets, but is more rigorous in what capital forms are acceptable. It also proposed:

- An additional layer of common equity that could not be breached without a restriction on dividend payouts;
- Additional capital and liquidity requirements for banks whose failure would threaten the financial system;
- A new overall restriction on unweighted leverage of capital to assets; and
- A requirement that banks have sufficient liquidity to meet a 30 days' run on their deposits.

The change in capital requirements between Basel I and Basel III is more evident in the kind of assets that qualify as capital than in the overall ratio of capital to risk-weighted assets: Equity is now required, where borrowings with some equity-like characteristics once sufficed. When fully phased in (by 2019), banks will need common equity of 4.5 per cent compared with two per cent in Basel I, and Tier 1 capital (which includes common equity) of six per cent compared with four per cent in Basel I. There will also be an additional requirement of 2.5 per cent of common equity as a capital buffer.

Banks deemed globally or nationally systemically important will need to meet higher capital requirements. There will also be a leverage ratio imposing a requirement of three per cent of capital against unweighted assets to be phased in gradually. The liquidity requirement to meet a 30 days' run will be fully phased in by 2019.

The new capital and liquidity rules have been satisfactorily advanced. National jurisdictions have either adopted them or are well on track to do so. This achievement should not be underestimated. For most regulated financial institutions, equity capital requirements are, or will be, four-times higher than under the Basel I rules and five-times higher for globally systemically important institutions.

“The new capital and liquidity rules have been satisfactorily advanced. National jurisdictions have either adopted them or are well on track to do so. This achievement should not be underestimated.”

Also well advanced in implementation, but still encountering difficulties, are the guidelines to strengthen supervision of bank risk management, to control risks in securitisation of banks assets and trading book exposures, and to develop new standards on compensation practices.

The changes are not without cost – to banks and to the public. In a 2011 study¹², the Organisation for Economic Co-operation and Development (OECD) estimated that the capital requirements for 2015 would add around 10-to-15 basis points (a basis point is one-hundredth of a percentage point) to the funding costs of banks. The full suite of changes to capital requirements to be introduced by 2019 (i.e. seven per cent for the common equity ratio and 8.5 per cent for the Tier 1 capital ratio) would cost 50 basis points.

The OECD also estimated there would be a very small but discernible impact on output growth. The cost should be balanced against the diminished risk or frequency of vastly greater losses if the bank regulatory framework was not made more rigorous¹³.

In dealing with the treatment of financial institutions TBTF, the FSB gives itself a tick for policy development, but concedes that implementation is unsatisfactory across the G20 members.

“As the finance reform work moves further away from amending regulatory rules existing before 2008 and into new areas, implementation becomes more ragged.”

The various agencies have developed frameworks to resolve failing big global financial institution banks, increase their loss provision and the regulatory scrutiny applied to them. The agencies have developed counterpart programs for domestically systemically important banks and developed recommendations to increase the autonomy and resources of regulators, their mandates and their expertise.

National implementation for most of these measures has been slow and uneven. It has proved particularly difficult to reach agreement on the resolution of large cross-border finance failures, such as Lehman Brothers. (Even today, the resolution of claims against Lehman is far from complete.)

As the finance reform work moves further away from amending regulatory rules existing before 2008 and into new areas, implementation becomes more ragged. This is true of reforms to OTC derivatives, and extending regulatory net to capture shadow banking, including hedge funds. US money market mutual funds remain vulnerable to runs, which would force the funds to redeem loans.

Australian adoption of regulatory reforms

Australia has not only adopted the finalised proposals, it has played a significant role in the committee work producing them. Australia is a member of the G20, the FSB, the BIS, the International Association of Insurance Supervisors and the International Organization of Securities Commissions (IOSCO), as well as the OECD and the IMF, all of which are involved in the reform program.

In March 2014, a BIS team examined¹⁴ Australia’s adoption of the BCBS agenda, rating it ‘compliant’ in most areas, and ‘largely compliant’ in a couple of areas. By the second half of 2013, Australia was among the leaders in the speed and completeness with which it had adopted the reform agenda.¹⁵

There remains a considerable agenda to implement, including some proposed changes most resisted by Australia’s banks. Even so, APRA, and more broadly, the Council of Financial Regulators, have moved well ahead of many other jurisdictions.

Australia has:

- Issued final Basel III capital rules that are now legally in force. Some of the capital measures have been put in place two or three years before the deadline required under Basel III (APRA also plans to implement new liquidity requirements by 1 January 2015, again in advance of the Basel III deadline);
- Developed an initial draft of stricter rules for domestic systemically important banks, which in the Australian case, are the Big Four – APRA's crisis-management powers have already been strengthened;
- Acquired powers to impose mandatory central clearing, trade reporting or platform-based execution requirements on transactions that are now OTC; and
- Acted to strengthen financial market infrastructures, such as security settlement facilities and central counterparties.

Australia has done less on shadow banking, like most other G20 members. In Australia's case, shadow banking is much less important than, for example, in the US, reflecting the dominance of the regulated banking system in Australia and the relatively greater role of market-based credit intermediation in the US.

Regulatory reform is of course only one influence on the finance sector. In the Australian case, market trends have reduced financial stability risks. In 2007 and into 2008, global term lending to banks dried up as worries about bank soundness became widespread. This threatened Australia's funding base, which partly relied on offshore borrowing. That unpleasant experience, combined with a sharp increase in saving by Australian households, caused Australian banks to substantially reduce their reliance on offshore term funding in favour of domestic retail deposits.

Completing the current global agenda

Much remains to be done in implementing the agenda adopted in 2008. The new capital requirements for banks are basically concluded, and implementation is said to be on track. Even so, the earliest time at which implementation is likely to conclude is 2019. Additional capital requirements for systemically important banks, globally and nationally, have also been agreed, though not yet implemented.

There is still a lot to do in quantifying shadow banking and its connections with regulated banking, let alone agreeing upon and then implementing reforms that would materially reduce the risks posed by this sector (with that said, much has been done by national regulatory authorities, especially in the US). While regulators know what they want to do with OTC derivatives markets, it largely hasn't yet been done. Even in areas where there is agreement – and in some cases, national implementation – there is a long tail of assessments, peer reviews, further research and so forth that will take many years to complete.

Meanwhile, new issues arise. Some of these issues require amending what has already been agreed. Though the Basel III capital rules have been agreed upon, a new work stream is now reviewing the comparability of risk-weighting calculations across banks and jurisdictions. Financial market transactions often depend on reference rates, so manipulation of the London Inter-Bank Offered Rate (LIBOR) when exposed became a new issue requiring reform. The same may be true of foreign exchange markets. New national rules may cut across global rules, in some cases requiring revisions, in other cases requiring assessments of the impact of the national rules on global rules. The US, for example, has implemented regulations under the US Dodd-Frank legislation to constrain proprietary or own-account trading by financial institutions, i.e. the ‘Volcker rule’. The UK proposes a more liberal but quite constraining rule in which trading activities would be structurally separated into a different legal entity from the bank holding the retail deposits. The EU proposes to ban principal trading for very big banks, with possible structural separation of trading activities of smaller entities. The three major advanced-economy banking markets are thus proposing different rules on the key issue of trading activities, though major finance businesses will be operating across all three jurisdictions.

“Extended over such a long period and with many new issues presenting themselves along way, the entire reform agenda is inevitably becoming an indefinite process rather than a set of tasks to be accomplished within a limited time.”

Extended over such a long period and with many new issues presenting themselves along way, the entire reform agenda is inevitably becoming an indefinite process rather than a set of tasks to be accomplished within a limited time.

2014 Brisbane Summit

Though the Brisbane Summit is loosely characterised as completing the agenda reform endorsed by the G20 in the aftermath of the GFC, the ambition for the meeting is far more qualified. As FSB Chairman (and Bank of England Governor), Mark Carney, wrote to G20 finance ministers and central bank governors in April 2014¹⁶, the goal is “substantially completing” the “core” of the G20 program of financial reform during Australia’s presidency. Since Australia’s presidency ends soon after the Brisbane Summit, and the summits usually endorse outcomes that officials have already agreed upon, the real deadline for completion is well before this November.

Though ambitious to do more, the Brisbane Summit is unlikely to complete the G20 established program of fundamental reform, let alone address the new agenda of financial stability reform identified by policymakers and researchers in the six years since the GFC. The FSB itself is now proposing a new agenda that will go well beyond the Brisbane Summit.

As Carney reports, difficult decisions remain to be taken in:

- Addressing the TBTF problem;
- Making shadow banking transparent with resilient and market-based financing; and
- Making derivatives markets safer.

Consideration of these issues is likely to extend beyond the Brisbane Summit.

The objective in dealing with TBTF is to resolve a big, failing institution without the need for taxpayer support and without disruption to the rest of the financial system. During the GFC, for example, the US credit derivative insurer American International Group (AIG) had to be bailed out because its failure would have threatened the whole system. The increase in capital requirements for systemically important institutions makes such failures less likely, but the TBTF agenda recognises that the risks of a failure remain substantial.

The two major measures to be presented – though unlikely to be resolved – at the Brisbane Summit are:

1. Sufficiency of the aptly named ‘gone-concern loss-absorbing capacity’; and
2. Contractual or statutory arraignments for cross-border resolution of failing institutions.

Neither are simple to devise or easy to agree. Cross-border resolution has proved among the hardest nuts to crack because of national legal and regulatory systems. Increases in the loss-absorbing capacity left *after* failure must, by definition, be in addition to those requirements designed to make failure unlikely.

The leaders in Brisbane will also be asked to move forwards the agenda on shadow banking. Part of the problem of dealing with shadow banking is that national authorities have only recently begun to assemble the information necessary to define the nature and size of the sector. Even now, the connections between shadow banks and the regulated banking system are known only cursorily¹⁷. Accordingly, the proposals for the Brisbane Summit in this area cover information sharing and agreement on a supervisory framework before the meeting, and a peer review on national implementation after the meeting. The proposals, however, do not appear to yet have a clear plan for the meeting itself. So too for the objective of making derivative markets safer: The FSB chair is able to specify a number of reports to be concluded before the meeting, but does not promise a proposal for the meeting itself. As Carney notes, OTC-derivatives reform is overdue.

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One proposal Carney hopes to bring to the Brisbane Summit is for changes in the structure of the FSB itself. Since the reported survey of member’s views suggests no wish to change its present size and configuration or the present criteria of economic and financial size in determining membership, little change appears likely

– other than a greater readiness to involve other national authorities on policy work where relevant.

In a June 2014 assessment¹⁸ of progress in the four key regulatory themes that Carney identified for the Brisbane Summit, RBA Governor, Glenn Stevens, pointed out that while the Basel III reforms had been agreed upon and an implementation schedule accepted, markets evidently remained doubtful about the rigour of stress tests of European banking risks and the quality of their balance sheets. In this context, a final implementation date of 2019 was sufficiently far off to pose the risk of another economic downturn intervening before banks were adequately capitalised. While Basel III reforms were on track, reform of derivative markets to increase transparency, platform trading and central clearing “are running behind original timetables,” Stevens said.

In understanding the interaction of regulatory arrangements in different jurisdictions, Stevens pointed out, “we have a way to go yet.” In shadow banking, he called for more recognition that while shadow banks could raise issues for financial stability, the oversight should not attempt to eliminate risk. Rather, it should focus on limiting the consequences of failure (and success) to the risk-takers rather than the system as a whole.

On the fourth issue that Carney proposes for the Brisbane Summit, Stevens argued it would be difficult to completely eliminate the possibility that national authorities would need to support the resolution of institutions that had run through all the capital buffers proposed, and whose outright failure would pose a risk of contagion to the rest of the financial system.

Beyond the Brisbane Summit

Perhaps the most important work of the Brisbane Summit in the sphere of financial stability is not to substantially complete the agenda of the past six years, but to decide the form and extent of a new agenda for the coming decade.

Even for the current agenda, there is much yet to complete. As Carney remarks in his April letter, the agenda beyond the Brisbane Summit could include peer reviews, more work on outcomes-based approaches to resolving cross-border issues, and cooperation to “avoid domestic measures that fragment the global system”.

Regulators are constrained by lack of time and trained people. In Australia, the major regulators, APRA and the Australian Securities and Investment Commission (ASIC), are under firm budgetary pressure to effect economies, while carrying out their normal supervisory functions, negotiating and implementing new rules, and participating in global negotiations on what remains of the 2008 agenda and the development of a new reform agenda. The fact that regulators now need time to implement an agreed set of changes motivates Stevens’ reluctance to pursue a new and major round of reforms.

By contrast, the IMF's Claessens and Kodres summarise the outcomes to date, "at this juncture, several years beyond the height of the crisis, the financial reform agenda is still only half-baked at best ... some reforms gesture in the right direction ... [but they] don't go far enough or have not been implemented fully". While Basel III is well defined and is – or will be – widely implemented, it mostly 'tweaks' the long tradition of regulation built on bank capital. By contrast, the whole area of shadow banking, which after all was at the genesis of the GFC, has progressed more slowly partly because there is insufficient data and theoretical understanding of how the various shadow banking markets work¹⁹. That said, the issues picked up by the IMF analysts predominantly pertain to the US financial system and the progress in remedying those issues ultimately depends on US rather than global action.

There's no doubt of the considerable achievement in financial market regulation over the past six years. Banks have – or will have – bigger capital buffers, giving them more resilience against write downs of their loan books in an economic downturn. As capital is higher, deposits with banks and loan funding for banks is less at risk.

The new liquidity requirements mean that financial institutions experiencing a decline in their funding have more assets they can quickly sell to meet their obligations. Systemically important banks, the ones that cause the most trouble for the global financial system when they are distressed, will have more capital than their less prominent competitors will – and perhaps less reason to get bigger. A higher share of derivative products will be traded in open markets, and the impact of derivatives on the balance sheets of financial institutions will be clearer. In the US, financial institutions will have less freedom to speculate on their own balance sheets, constraining a major source of profits while constraining a major source of risk.

These changes and the many smaller reforms previously mentioned are all worthwhile and will contribute something to greater financial stability. However, it is wrong to conclude that these changes have of themselves eliminated the probability of another financial crisis – or even reduced that probability. Even if their more ambitious program was adopted and implemented, Claessens and Kodres write, "crises will likely recur".

It remains the case that banks borrow short and lend long. They engage in 'maturity transformation'. This is the age-old and unchanging rationale of banking. Banks still attract deposits at call or for relatively short terms, and they lend for long terms for the acquisition of long-lived assets like houses, cars or factories. They are vulnerable to swift deterioration of their funding base. Banks are also highly interconnected. They make loans to each other and accept deposits from each other. They are vulnerable to the unexpected weaknesses of other banks. These characteristics are ones that society rightly accepts as acceptable risks in financing the acquisition of assets or the smoothing of consumption over lifetimes.

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They mean, however, that if for any reason the funding base is abruptly withdrawn, a bank will have to look at quickly disposing of illiquid assets in what is usually in those circumstances a weak market. The size of the capital buffer and the proportion of liquid assets like government bonds make a difference.

In the face of a persistent loss of confidence and deposit withdrawal, the capital buffers are soon crushed and the liquidity exhausted. The reason for the decline in the funding base may be rational or irrational, and for the issue of the stability of the financial system as a whole it really doesn't matter as the consequences for the financial system are the same. Since banks are highly interconnected, problems of any one big bank are problems for the rest.

“Since banks are highly interconnected, the problems of any one big bank are problems for the rest of them.”

Even where financial institutions do not accept deposits from, or lend to, the public, their balance sheets may have similar vulnerabilities. Financial institutions may, for example, borrow in a professional short-term market such as the overnight money market, and use the borrowing to purchase less liquid but higher yielding assets. This ‘liquidity transformation’ is similar to ‘maturity transformation’ – and sometimes indistinguishable from it.

In a suddenly weak market, these institutions may be asked to pay back debt but be unable to realise anything like the expected value for their assets. Even if only one institution is affected, its fire sale of assets will compel similar financial institutions to write down the value of similar assets, reducing their capital buffers. These were the mechanisms at work during the GFC, as the problems of one investment infected another, and finally much of the global financial system.

The reforms do not prevent crises of this kind re-occurring, and were not intended to do so. These endemic characteristics of banks explain why governments, usually through the national central bank, stand ready to lend to a systemically important commercial financial institution experiencing what may be temporary inability to meet withdrawals. An assurance that the central bank will assist is usually enough to stop the flight of deposits. But it will never be enough to limit intervention to the temporary difficulties of otherwise sound financial institutions.

The failure of an unsound bank can do as much damage to national prosperity as the failure of a sound bank. It is certainly true that an unsound institution can be and should be unwound in a way that punishes management, shareholder and bondholders with sufficient severity to discourage risky behaviour. The intervention will nonetheless often be necessary or at least well advised.

These endemic issues remind us that the really important regulatory activity is consistent, rigorous oversight to check the growth of risky practices *before* they endanger a financial institution, and more importantly, its counterparties. The regulatory oversight needs to go beyond the inner core of traditionally regulated banks with recognised access to lender of the last resort facilities. It needs to intrusively examine all the major players – the whole of the shadow banking system, as well as that inner core of commercial banks – whose failure may endanger other players and the system as a whole.

This kind of relentless, intrusive and universal scrutiny is entirely foreign to the ruling doctrine that markets know best, that financial institutions are best judges of their risks, and that innovation should be encouraged rather than impeded. It is also hostile to the interests of market participants in earning big rewards from taking what they regard controlled risks. Despite the GFC and its aftermath, this doctrine remains predominant.

The likelihood of more financial crises also reminds us that crisis management is important. Even in Australia, which has a smaller shadow banking system than most, a larger (and oligopolistic) regulated banking system than most, and a reasonable degree of regulatory oversight, APRA has had to fight hard to enforce tougher banking rules. Most recently, it has been compelled to fight back against planned budget cuts.

The far more important challenge for the G20, therefore, is not to complete an existing agenda but to refresh a commitment to global scrutiny in response to continuing globalisation of national financial systems, the changing configuration of financial institutions and financial markets, and the still serious risk of costly financial instability.

IMF experts, Claessens and Kodres, suggest introducing a new agenda that emphasises system-wide scrutiny to capture emerging risks evident in transactions between different kinds of institutions; pays more attention to aligning market participant incentives with social goals; and recognises that future crises will quite likely emerge from risks yet unknown²⁰. But the wide scope and lack of concrete measures in this proposed program mean it depends far more on further and continuing research and changing regulatory culture than does the earlier program of renovating the already established rules of prudential supervision.

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Even after the completion of the entire reform program initiated after the GFC, the probability and scope of any future financial crisis is more likely to depend on the quality of risk oversight than the regulatory framework – though the two are, of course, related.

Australia and China have both adopted and implemented almost all of the reforms proffered by the BCBS. Yet there is little doubt the risks of a global financial crisis beginning in China are higher than the risks of a global financial crisis beginning in Australia. China’s financial system is vastly bigger and must make the difficult transition to a price-based system already achieved decades ago in Australia. In addition, the quality of the regulatory oversight in China has had less time to develop and learn from earlier mistakes. A country’s score on global regulatory reform adoption is only one element in an assessment of the financial stability risks it presents.

For Australia, the six reform years have been useful but not transformative. With prompt and substantial government support including loan guarantees, emergency interest rate settings and the orderly reconstruction of a couple of distressed lenders, the Australian financial system weathered the GFC well compared with those in the US, the UK and Europe.

While major reform in Australia has not been required, some important changes have been made. Broadly, the changes increase the liquidity and the capital buffers of banks. However, it is difficult to claim that the changes made since 2008 remove the need for the extraordinary measures taken by the Australian Government, central bank and financial system regulators should similar circumstances arise.

The gravest danger in completing the program of financial reform initiated six years ago is encouraging an illusion that the requirement for regulatory authorities' continuous probing and intrusive vigilance can now be relaxed, and that governments can once more rely on financial institutions themselves to manage the risks they pose to the economy.

“The gravest danger in completing the program of financial reform initiated six years ago is encouraging an illusion that the requirement for regulatory authorities' continuous probing and intrusive vigilance can now be relaxed.”

It would also be dangerous if governments convinced themselves they are unlikely ever to have to deploy the traditional tools (e.g. lender of the last resort support, taxpayer support for deposits and some other liabilities of failing banks, and stimulatory fiscal and monetary policies) to respond to future financial calamities.

As RBA Governor, Glenn Stevens²¹, argues:

“At some point requiring more and more loss absorbency to be provided by the private sector will come at an increasingly steep price. There must be events sufficiently far into the tails of the relevant distributions that no private balance sheet can reasonably be expected, ex ante, to bear the associated loss, no matter what the price. Should such an event occur, policymakers will still face the decision of whether to close or support the institution. The policy task is not, in my view, one of ensuring that the probability of such an event is absolutely zero, but of making it acceptably low at an acceptable price.”

Timothy Geithner (President of the Federal Reserve Bank of New York and then US Treasury Secretary during the GFC) observes, crises are sure to recur²², and:

“Faced with a severe crisis, you want to deploy overwhelming force. You want the force to be large relative to the size of the problem. It looks imprudent. You're creating moral hazard. People will criticize you for rescuing the arsonist. But if you don't do it, the outcomes will be much more damaging and tragic.”²³

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3. The role of the G20 in taxation regulation

Professor Kerrie Sadiq

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This chapter explores the status of the current programs designed to address global tax avoidance, critiques the role that the G20 plays in the reform agenda, and considers the part that Australia will play in the process.

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Introduction

The G20 Summit in Brisbane will focus on promoting stronger economic growth and making the global economy more resilient to deal with future shocks. Given the significance of tax revenue to the fiscal soundness of sovereign nations and the role it plays in the global economy, along with the current G20 and Organisation for Economic Co-operation and Development (OECD) focus on base erosion and profit shifting, Australia is in a unique position to play a significant role in shaping and promoting the international tax reform agenda.

Any reform clearly requires international consensus and multilateral adoption, which is delicate to facilitate. As such, Australia needs to ensure it not only contributes to the substantive policy issues of the international tax reform agenda thereby ensuring momentum in what is an ambitious task, but that it is also politically astute in managing the process and expectations of all the stakeholders. This includes not only the members of the G20, but also OECD members, developing nations and emerging economies, commercial entities, civil society groups and the global community.

Background: International tax regime

The inadequacies of the current international tax regime are becoming increasingly obvious. Current systems are failing to tax multinational entities where the business activities that give rise to the profits take place. Data limitations mean that it is difficult to estimate the cost of aggressive tax planning. Media exposés on entities such as Apple, Starbucks, Amazon, Vodafone and Google highlight the mismatch between the jurisdiction of the economic activities that give rise to an entity's profits and the amount of income tax paid within those jurisdictions. For instance, Apple paid tax at the rate of 0.7 per cent of its turnover to the Australian Taxation Office (ATO) for 2012–13.¹ Similarly, Starbucks paid no income tax in the prior three years on sales in the United Kingdom of £1.2 billion.² In essence, these multinational entities are engaging in what has commonly become known as 'base erosion and profit shifting' (BEPS).

Since the first G20 Summit in 2008, each of the annual meetings has discussed the need for international tax cooperation, whether in the form of the promotion of international exchange of tax information and transparency, tackling tax havens, or addressing BEPS. The 2009 London Summit is often viewed as the turning point in the international effort to combat tax havens³, with continued momentum and expanded agendas since.

"It has become the responsibility of Australia during its G20 leadership tenure to ensure that tangible progress is made. To that end, tax is one of the 10 G20 priorities for 2014."

The broader tax agenda was most recently articulated at the 2013 St Petersburg Summit where the G20:

- Endorsed the OECD BEPS Action Plan;
- Welcomed the establishment of the G20/OECD BEPS project;
- Committed to automatic exchange of information as the new global standard; and
- Acknowledged that developing countries should also be able to benefit from greater tax information exchange.⁴

The G20 Leaders' Declaration broadly outlined these outcomes and commitments from the St Petersburg Summit but left much of the technical work to the OECD. Consequently, from a G20 perspective, it has become the responsibility of Australia during its G20 leadership tenure to ensure that tangible progress is made. To that end, tax is one of the 10 G20 priorities for 2014. However, as evidenced by the work being undertaken in the lead up to the Brisbane Summit, tax is likely to take on greater significance than some other priorities.

Specifically, the 2014 G20 agenda is slated to focus on three related international taxation reform priorities:

1. Addressing tax avoidance, particularly BEPS, to ensure profits are taxed in the location where the economic activity takes place;
2. Promoting international tax transparency and the global sharing of information so that taxpayers with offshore investments comply with their domestic tax obligations; and
3. Ensuring that developing countries benefit from the G20's tax agenda, particularly in relation to information sharing.⁵

There is no doubt that current tax regimes have failed to keep pace with an increasingly global economy. The result is that multinationals are able to take advantage of the outdated international tax laws to minimise their tax liability, that is, partake in BEPS. Each of the three broad areas listed attempts to address different aspects of this trend. As chair of the G20 in 2014, Australia has the opportunity to play a leading role in shaping the international tax reform agenda to address these issues.

Priority 1: Tax avoidance

The first of the international tax reform priority areas is to address tax avoidance, or BEPS, to ensure profits are taxed in the location where the economic activity takes place. Taxation is a matter for domestic law; however clashes between different national regimes mean the possibility of double taxation. As such, since the 1920s, standards have been designed to eliminate double taxation to remove impediments to trade and economic growth.

Today, we have a system of commonly accepted international tax principles and thousands of double tax treaties globally. These are designed to prevent the double taxation of profits from cross-border activities. Increasingly however, these rules are interacting to allow for less than single taxation, that is, double non-taxation, or at the very least, a distortion in the amount of tax paid along with the location in which it is paid. This generally occurs because of tax planning techniques where there is artificial separation of the income from the activities that created it. That is, profit shifting by multinational entities resulting in tax base erosion.

Base erosion is the ability of multinational entities to take advantage of the current international tax regime, with the advantage achieved by leveraging the gaps in the regime that “provide opportunities to eliminate or significantly reduce taxation on income in a manner that is inconsistent with the policy objectives of such domestic tax rules and international standards”.⁶

Profit shifting is one of the most significant ways in which base erosion is occurring. Multinational entities are able to profit shift because the current international

tax regime relies on the traditional concepts of residence and source, along with the notion of the permanent establishment and transfer pricing regimes imposing an arm's length standard for related party transactions.

In essence, these concepts focus on physical locations and a separate entity approach. This is in stark contrast to the reality of global corporations. In practical terms, profit shifting is generally achieved via:

- Transfer pricing practices, particularly with respect to the shifting of risks;
- Shifting of intangibles;
- The splitting of the ownership of assets; and
- Undertaking transactions within the multinational group that would not normally occur between non-related parties.

Addressing BEPS

The OECD is undertaking the current work on BEPS at the request of the G20 Finance Ministers. In February 2013, the OECD delivered its first BEPS report.⁷ This was followed by its Action Plan,⁸ which was introduced at the G20 Finance Ministers' meeting in Moscow. The plan identifies specific actions needed to provide countries with domestic and international instruments to address BEPS.

The specific actions, which are high-level policy objectives, are:

1. Address the tax challenges of the digital economy;
2. Neutralise the effects of hybrid mismatch arrangements;
3. Strengthen controlled foreign company (CFC) rules;
4. Limit base erosion via interest deductions and other financial payments;
5. Counter harmful tax practices more effectively taking into account transparency and substance;
6. Prevent treaty abuse;
7. Prevent the artificial avoidance of 'permanent establishment' status;
8. Assure that transfer pricing outcomes are in line with value creation for intangibles;
9. Assure that transfer pricing outcomes are in line with value creation for risks and capital;
10. Assure that transfer pricing outcomes are in line with value creation for other high-risk transactions;
11. Establish methodologies to collect and analyse data on BEPS transactions;
12. Require taxpayers to disclose their aggressive tax planning arrangements;
13. Re-examine transfer pricing documentation;
14. Make dispute-resolution mechanisms more effective; and
15. Develop a multilateral instrument.

The Action Plan highlights a broad and comprehensive list of problems associated with the international tax regime. The project is regarded a process of reform rather than a wholesale or one-off remodelling of the current system. Common themes among the actions can be summarised into three broad categories:

1. The design of international standards to ensure the coherence of corporate income taxation at the international level;
2. The need to address the weaknesses in the current domestic laws and tax treaties that allow multinationals to artificially shift the taxable income to a different location to where the activities that gave rise to the income are performed; and
3. Ensuring transparency in a broader sense than what is being achieved.⁹

The BEPS project, with its ambitious two-year timetable, is due for completion 12 months after the Brisbane Summit. However, Australia's role in the BEPS project goes beyond its G20 presidency, with its OECD membership resulting in representation on all of the OECD working groups and committees involved in the G20/OECD BEPS project. As such, Australia has the advantage of being able to synergise and capitalise on its involvement in the broader reform program through its G20 presidency. To that end, in the lead up to the Brisbane Summit, Australia has been proactively encouraging discussions around the tax reform agenda.

Australia hosted the G20 International Tax Symposium in Tokyo, Japan on 9–10 May 2014. The symposium, with over 200 delegates from nearly 40 countries, aimed to discuss developments in international taxation focusing on the key items of the G20 tax agenda. To date, details of the outcomes from the symposium were limited to opening and closing addresses. These indicate that there is considerable commitment and momentum to all three priority areas.¹⁰

BEPS is a multifaceted problem with no clear or apparent solutions. Any measurable outcomes require a significant degree of cooperation and consensus from all nations. This is where the potential difficulty lies. While no one doubts that the BEPS problem is substantial, substantive solutions require nations to balance sovereignty issues with a strengthening of the consensus-based framework. Possible reforms may also require a consideration of a move away from traditional developed nation/OECD models and practices to models that better reflect the reality of the modern global economy and the structure and form of multinational entities. Unfortunately, there is very little indication that 'bold' steps will be suggested in any reform proposals, with the OECD Action Plan stating, "rather than seeking to replace the current transfer pricing system, the best course is to directly address the flaws in the current system."¹¹

"BEPS is a multifaceted problem with no clear or apparent solutions. Any measurable outcomes require a significant degree of cooperation and consensus from all nations. This is where the potential difficulty lies."

Priority 2: International tax transparency

The second of the international tax reform priority areas is to promote international tax transparency and the global sharing of information so that taxpayers with offshore investments comply with their domestic tax obligations. Greater transparency is called for on the basis that it increases compliance with the existing laws and informs public debate. Transparency initiatives complement the work being done on the substantive BEPS aspects.

Transparency is not well defined, and in the international tax arena, it often means different things to different stakeholders. It can also have different purposes, be disclosed by and to different stakeholders, and vary in nature and the level of information. The exchange of information between taxing authorities has been the traditional means of administratively addressing less than single taxation, and as such, is generally understood to be what is meant by transparency. However, more recently, there have been calls for greater taxpayer transparency in the form of mandatory taxpayer reporting of specific information pertaining to their international activities.

Broadly, there are two ongoing transparency initiatives of the G20 and OECD:

1. Automatic exchange of information; and
2. Mandated taxpayer disclosure.

Automatic exchange of information

Prior to the G20/BEPS program, much of the initial G20 international tax focus was on international tax transparency. The success of the G20 in shaping the transparency agenda and driving reform is testament to the influence it can have on tax policy. In particular, at the 2009 London Summit, there was a marked change in direction in policy on international tax transparency in an attempt to address financial secrecy. More specifically, there was a “call on countries to adopt the international standard for information exchange endorsed by the G20 in 2004 and reflected in the UN Model Tax Convention”.¹² Further, the G20 noted the OECD’s list of countries assessed against the international standard for exchange of information, and stated it stood ready to take agreed action against those jurisdictions that did not meet international standards in relation to tax transparency.

The OECD/Global Forum coordinates much of the effort attempting to prevent tax evasion through both tax havens and non-tax havens. Work has been done in the area of transparency and exchange of information. Both OECD and non-OECD economies have carried out this work since 2000, but the emphasis has always been on the promotion of information exchange upon request, which had been portrayed by the OECD-hosted Global Forum as the “internationally agreed standard”. However, in June 2012, the OECD recognised that in practice, many

of its member nations were participating in automatic exchange of information and formally endorsed it.

The OECD stated, “as automatic exchange of information becomes a growing practice, the OECD stands ready to offer a multilateral platform to implement this practice to all interested countries, including by standardising technical formats and investment in information technology.”¹³ The OECD defines automatic exchange of information as the systematic and periodic transmission of ‘bulk’ taxpayer information by the source country to the residence country concerning various categories of income.¹⁴

The G20 has continued to work closely with the OECD in relation to the automatic exchange of information with successful outcomes. In February of this year, the G20 agreed to implement a global standard for automatically exchanging information between tax authorities, with implementation to be complete by the end of 2015. G20 governments mandated the OECD-hosted Global Forum on Transparency and Exchange of Information for Tax Purposes to monitor and review the implementation of the standard. In May, the OECD announced the endorsement of the *Declaration on Automatic Exchange of Information in Tax Matters* by all 34 member countries, along with Argentina, Brazil, China, Colombia, Costa Rica, India, Indonesia, Latvia, Lithuania, Malaysia, Saudi Arabia, Singapore and South Africa.

While there is still work to be done in the area of automatic exchange of information, it appears that the G20’s involvement in the project can be hailed a success. However, automatic exchange of information is not without problems, especially for developing nations, which are often unable to benefit from the information due to lack of capacity.

Mandated taxpayer disclosure

Automatic exchange of information can provide a limited amount of information where that information is shared between relevant revenue authorities. However, it does little in the way of assisting other stakeholders. As such, calls for additional taxpayer accountability in the form of country-by-country reporting have been growing in magnitude over the last decade. There are now numerous civil society groups that advocate for such reporting and support the view that increased disclosure will inform the public about the activities of multinational entities on a jurisdictional basis.

At first glance, it may seem that country-by-country reporting is on the G20 agenda because mandated taxpayer disclosure specifically falls within the scope of the BEPS project. However, this may not be the case. Recommendations are being developed regarding the design of a system that requires mandatory disclosure rules for aggressive or abusive transactions, arrangements or structures.¹⁵ However, it seems that the OECD views on mandatory reporting may vary from that of a broader sector view because the scope of the BEPS project mandate is limited.

First, it seems that the OECD and the G20 have adopted the view that the point of mandatory reporting is providing tax authorities with information. Yet much of the purpose of country-by-country reporting is to inform the public about the activities of multinational entities to allow an informed assessment of how those entities affect society.

Second, the information required to be disclosed may be more limited than what proponents of country-by-country reporting envisage. A broader reporting framework proposed by a leading tax reform advocacy group, the Tax Justice Network, suggests that a best practice model would require a multinational entity to report:

- The name of each country where it operates;
- The names of all its subsidiaries and affiliates in these countries;
- The performance of each subsidiary and affiliate, without exception;
- The tax charge in its accounts of each subsidiary and affiliate in each country;
- Details of the cost and net book value of its fixed assets in each country; and
- Details of its gross and net assets for each country.¹⁶

Disclosing employee details, including both cost and number, is also suggested as part of a comprehensive reporting model. However, current indications are that the OECD reporting requirements will not go this far. To this end, the G20 can seek feedback from all stakeholders, support a comprehensive reporting framework and adopt a wide purpose for such reporting rather than a limited (and potentially confidential) regulatory authority-only reporting regime.

Priority 3: Benefits for developing countries

Truly global reform requires not only a consideration of developing nations and emerging economies, but also participation by representatives of all members of the international community. However, it has generally been the OECD, with its developed nations' membership, that has taken the lead on international tax reform.

The need to include developing nations and emerging economies is especially apparent in an era in which there is rapid economic growth in these countries. Unlike a century ago, when the current international tax rules were developed, it is no longer the case that the majority of international economic activity occurs between OECD nations. As such, developing nations are concerned about their lack of representation at the OECD. The G20 partially fills this gap.

Perhaps the most important in ensuring genuine global success, but the least developed item on the G20 tax agenda, is the need to ensure that developing countries also benefit from any outcomes and commitments. Unfortunately, this may also be where the G20 fails to make any significant and substantial headway.

The focus statement specifically states that the aim of the G20 is to ensure that developing countries benefit from the G20 agenda in relation to information sharing. While this is a noble goal, information sharing alone will not help

developing nations solve the problems they face in relation to BEPS. In particular, many developing nations are missing out on their 'fair share' of tax revenue because the current international tax regime allows multinational entities to shift the profits from where they are earned to another jurisdiction through the use of the current transfer pricing regime and tax treaty network.

The OECD recognises this, stating:

"Developing countries often have no rules or ineffective rules for dealing with BEPS issues and lack the capacity to draft effective rules. They also face significant challenges in obtaining the relevant data and information to enable them to effectively implement their rules. The other major challenge facing developing countries is building the capacity to effectively implement rules based on international standards."¹⁷

If the G20 is to make meaningful progress in relation to developing nations and emerging economies, the nations themselves must be involved in the process. While some developing nations are part of the G20, these tend to be the larger and more developed nations. For example, at the G20 International Tax Symposium in Tokyo, Japan, there were very few delegates from developing nations, with numbers clearly swayed towards major accounting firms. This shows that a greater and more inclusionary effort could be made in this area.

This is not to suggest that the participants do not have the best interests of developing nations in mind. However, it is the developing nations themselves that experience the problems first hand. This is evident within the work of the United Nations (UN), which is one body that works closely with developing nations. In May 2013, the UN released a document complementary to the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Guidelines) known as the *Practical Manual on Transfer Pricing for Developing Countries* (UN Practical Manual). The UN Practical Manual devotes a chapter to the practices of Brazil, China, India and South Africa. In particular, the chapter outlines these nations' approach to transfer pricing. Each of the four nations that contributed was afforded the opportunity to set out its viewpoints and experiences applying the arm's length principle. (The current transfer pricing system requires related-party transactions to be valued at an arm's length price, i.e., the different parts of the multinational entity are treated as if they are independent for the purposes of determining a price to be attributed to the related transactions.) Given the same countries are members of the G20, the G20 may wish to consider the model adopted by the UN to allow these nations to also highlight nation- and region-specific issues as part of the current process.

Ultimately, not only should developing nations be given a say in addressing the flaws in the international tax regime, but the G20 also needs to ensure the focus isn't just on the priority areas of the OECD. OECD initiatives such as *Tax Inspectors Without Borders* to assist developing nations with their capacity building are commendable. However, such programs still work on a developed nation model and only address administrative insufficiencies. Again, given Australia's unique position in the Asia-Pacific region, it is imperative that its role in the G20 international tax reform agenda is broad and genuinely inclusionary.

Conclusion

The three priority areas may be addressed from an administrative level and/or as part of reform to substantive tax laws. To ensure the G20 and OECD produce tangible outcomes, reform must be undertaken at both levels. This is particularly significant with the BEPS project, which clearly highlights deficiencies in our current international tax regime. As the OECD stated in its Action Plan, unless effective solutions are developed in a timely manner, countries may adopt unilateral action to protect their tax base. This is not ideal and will not address the global issue of BEPS. Instead, it will lead to increased complexity and uncertainty in an already broken system.

While a financial estimate of BEPS globally is not possible, the fiscal implications are obvious. Any country that relies on corporate income tax as a revenue source is likely to continue to have their tax base eroded until the problem is adequately addressed. A higher corporate tax rate results in a greater fiscal impact. As such, Australia, with its above-OECD average corporate tax rate, has a stake in ensuring significant progress is made at the G20 in 2014. However, Australia's interest will also be best served by ensuring that any reforms adopt an inclusive approach that encompasses not only OECD nations but also places weight on the views of the G20 members that are emerging economies as well as non-member developing nations.

Less obvious consequences of not addressing the current problems associated with the international tax system should also be taken into account. First, access to aggressive tax planning techniques for some businesses but not others results in distortionary effects on the allocative efficiency of the economy. Flow-on consequences mean there is an erosion of the broader confidence in the tax system and an impact on developing nations that are forced to continue to rely on foreign aid rather than on a well-functioning self-sustaining system.¹⁸ To this end, Australia, as part of the Asia-Pacific region, must ensure that it adopts a broader agenda than that of the OECD by ensuring that developing nations and emerging economies participate on an equal footing. It should also ensure that the international tax reform agenda is placed within the broad setting of globalisation. The current system is broken because it has not kept pace with globalisation. Australia has a unique opportunity to highlight this and not only deal with the current problems but also offer solutions for the future.

Ultimately, history suggests that a tax reform agenda of the magnitude proposed by the G20 and the OECD is likely to be long term. Not only is there a significant degree of international consensus from regulators required, but stakeholders will also demand input. There is likely to be continued lobbying from the corporate sector, civil society groups and other interested parties. One could be led into

“While a financial estimate of BEPS globally is not possible, the fiscal implications are obvious. Any country that relies on corporate income tax as a revenue source is likely to continue to have their tax base eroded until the problem is adequately addressed.”

believing that this is merely the beginning of a long process with Australia currently sitting in the driver's seat and charged with ensuring progress and momentum for the future. Perhaps this is the case, but Australia also has a unique opportunity to play a significant role in shaping the future of international tax reform.

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Glossary

Arm's length principle

The current transfer pricing system requires related-party transactions to be valued at an arm's length price, that is, the different parts of the multinational entity are treated as if they are independent for the purposes of determining a price to be attributed to the related transactions.

Asian financial crisis

The Asian financial crisis was a financial crisis that began as a currency crisis in Thailand in 1997 and spread to neighbouring countries, with small effects felt in other countries in the world. The G20 was formed in the aftermath of the crisis.

Australian Prudential Regulatory Authority (APRA)

APRA is the regulator of Australia's financial services industry, including banks, insurance companies and members of the superannuation industry.

Automatic exchange of information

In taxation regulation, automatic exchange of information involves the transmission of taxpayer information by the source country to the residence country concerning various categories of income, e.g. dividends and salaries. It can provide a limited amount of information where that information is shared between relevant revenue authorities but does not assist other stakeholders.

Bank of International Settlement (BIS)

BIS was established in 1930 as an international financial organisation that serves central banks in their commitment to monetary and financial stability. It fosters international cooperation in those areas and acts as a bank for central banks. G20 tasked the BIS, through the Basel Committee on Banking Supervision (BCBS), with developing and implementing policies during the Global Financial Crisis.

Base erosion and profit shifting (BEPS)

BEPS occurs when companies, typically large multinationals, use loopholes such as profit shifting to avoid paying tax or to reduce the amount of tax they pay. BEPS means that countries are unable to tax entities at the location where the economic activity takes place.

Basel I

Basel Capital Accord I, shortened to Basel I, was released by the Basel Committee on Banking Supervision in 1988 and called for a minimum capital ratio of capital to risk-weighted assets of eight per cent. This has since been implemented in most countries in the world.

Basel II

Basel II came into force just as the Global Financial Crisis hit in 2008 and was an amendment to Basel I rules. It encouraged a bigger role for ratings agencies and bank risk assessment based on their internal models.

Basel III

Basel III is a set of reform measures to strengthen the regulation, supervision and risk management of the banking sector. It builds on Basel II and was issued in late 2010 in response to lessons learnt during the Global Financial Crisis.

Basel Committee on Banking Supervision (BCBS)

BCBS is a forum for international cooperation on banking supervisory matters. Members are from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The BCBS was tasked by G20 leaders to develop and implement financial system reform policies during the Global Financial Crisis.

Bretton Woods System

Established in 1944, the Bretton Woods System was an international system for exchanging one currency for another. Among other measures, members of the system had to peg their currencies to the US dollar. The system collapsed in 1971.

BRICS

BRICS refers to Brazil, Russia, India, China and South Africa, or a group of emerging economies that have the potential to become the major economies of the future. The BRICS are G20 members.

COP 21

The 21st Conference of the Parties (COP) is a meeting of the supreme body of the United Nations Framework Convention on Climate Change (UNFCCC) in Paris in 2015. The COP meets annually.

Credit intermediation

Credit intermediation is the act of taking money from savers and lending it to borrowers.

Derivative

A derivative is a type of financial contract that derives its value from another financial instrument, e.g. shares or bonds. Examples of derivatives include futures, forwards, swaps and options. The over-the-counter derivatives market played a significant role in causing the Global Financial Crisis.

Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly known as Dodd-Frank Act, is a bill that overhauled the US financial regulatory system. It was introduced in 2010 following the Global Financial Crisis.

European Union (EU)

The EU is an economic union, i.e. a type of trade bloc whereby member countries enjoy free movement of goods, services, capital and labour, with members coordinating some aspects of economic policy. The EU consists of 28 countries, i.e. Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and the United Kingdom. The EU is part of the G20 and is also generally represented at the G7/8, although it is not a member of the G7/8.

Eurozone

Eurozone is the common name used for the European Economic and Monetary Union, which comprises the 18 countries of the EU that have adopted the euro as their common currency. The Eurozone crisis has been ongoing since about 2009 and originated from some members' difficulty in paying back sovereign debt.

Financial Stability Board (FSB)

The FSB was established in 2009 as a successor to the Financial Stability Forum (FSF). Its aim is to coordinate at the international level the work of national financial authorities and international standard-setting bodies, and to develop and promote the implementation of effective regulatory, supervisory and other finance sector policies. The G20 expanded the FSF – which was formed by the G7 – into the FSB to provide better regulatory oversight of the international financial system.

Financial Stability Forum (FSF)

The FSF was the forum that preceded the FSB. It was formed in 1999 by the G7. Its aim was to enhance cooperation among the various national and international supervisory bodies and international financial institutions to promote stability in the international financial system.

Global Financial Crisis (GFC)

The GFC was a financial crisis that began in late 2007 in the United States and spread to much of the world in 2008. The G20 has been commended widely for the role it played in mitigating the effects of the crisis through international financial system reform.

Gone-concern loss-absorbing capacity (GLAC)

GLAC refers to financial institutions' (particularly those that are important to the system and likely to be too big to fail) ability to absorb losses when restructuring occurs, thereby avoiding the need for a government bailout. The Financial Stability Board is working on potential standards for GLAC.

Great Depression

The Great Depression was an economic crisis that began in 1929 in the United States when the stock market crashed. The crisis spread to the rest of the world. Its effects were felt through to World War II.

Group of Seven (G7)

The G7 consists of the finance ministers, central bankers and leaders of Canada, France, Germany, Italy, Japan, the United Kingdom and United States. It was formed in the 1970s and reflects the largest economies of that time.

Group of Eight (G8)

The G8 was created in the 1970s and consists of the seven G7 members and Russia. As of March 2014, Russia is temporarily suspended from the G8 due to the Crimean crisis.

G7/8

G7/8 refers to both the G7 and the G8. Since March 2014, the G7 and G8 are effectively the same group due to the temporary suspension of Russia from the G8.

Group of 20 (G20)

Formed in 1999, the G20 consists of the finance ministers, central bankers and leaders of the G7 countries (Canada, France, Germany, Italy, Japan, the United Kingdom and United States) plus Argentina, Australia, Brazil, China, India, Indonesia, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey and the European Union (EU). G20 finance ministers and central bank governors meet regularly and its leaders annually to discuss contentious policy issues that require international cooperation. The G20 played a crucial role in mitigating the effects of the GFC by fostering international cooperation for financial system reform. G20 leaders adopted principles for finance sector reform and tasked other organisations, such as the International Monetary Fund, to develop and implement policies as per those principles.

International Monetary Fund (IMF)

The IMF is an organisation of 188 countries (including all G20 countries), which aims to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world. The IMF plays an important role in working with the G20 and others to implement global financial system reforms.

Lehman Brothers

The Lehman Brothers was the first major US investment bank that filed for chapter 11 bankruptcy protection (administration) in 2008. Its failure is thought to have played a major role in the subsequent GFC.

Lender of last resort

Lender of last resort refers to an institution such as a central bank that offers loans to financial institutions in case of emergencies when they have no other means to obtain liquidity.

Liquidity transformation

Liquidity transformation is similar to maturity transformation but involves using cash-like (liquid) liabilities to buy illiquid assets such as loans.

London Inter-Bank Offered Rate (LIBOR)

LIBOR is a rate based on the interest rates at which banks offer to transact with each other on an unsecured basis in the London market. It is used as a reference for short-term interest rates.

Mandated taxpayer disclosure

The OECD is working on mandatory taxation disclosure rules to taxation authorities, including aggressive or abusive transactions, arrangements or structures.

Maturity transformation

Maturity transformation is the act of investing in long-term assets with short-term funds, mostly by borrowing money. In other words, they borrow short and lend long, which exposes the financial system to liquidity risk. It is particularly problematic when undertaken by unregulated institutions such as shadow banks.

Organisation for Economic Co-operation and Development (OECD)

The OECD is an international organisation of 34 member countries dedicated to global development. Formed in the 1960s, it is often dubbed the 'rich countries' club'. The OECD has been implementing international taxation regulation reform at the request of the G20.

Over the counter (OTC)

In finance, OTC refers to private transactions between financial institutions rather than open transactions in markets. OTC transactions lack transparency as prices and quantities are not visible to all market participants.

Shadow banks

Shadow banks are financial institutions that act like banks but are not counted as traditional banks for regulatory purposes as they are not deposit-takers, e.g. investment banks. As a result, they tend to go unsupervised and do not have access to lender of last resort facilities, i.e. they cannot borrow from the central bank in case of an emergency. The shadow banking system played a significant role in the GFC.

Too big to fail (TBTF)

In the finance sector, TBTF typically refers to banks or other financial institutions that are so large and so important to the economy that they cannot be allowed to fail as the effect on the economy would be disastrous.

Transfer pricing

Transfer pricing refers to the prices charged when one part of a multinational group buys or sells products or services from another part of the same group in a different country. The prices charged affects profit levels and, therefore, the amount of tax they have to pay in the respective countries.

United Nations (UN)

The UN is an international organisation founded in 1945 committed to maintaining international peace and security, developing friendly relations among nations and promoting social progress, better living standards and human rights. While more representative than the G20, the diversity of the UN's 193 members makes consensus difficult.

United Nations Framework Convention on Climate Change (UNFCCC)

The UNFCCC was adopted in 1992 as a response to global warming, with the objective of stabilising greenhouse gas concentrations in the atmosphere at a level that will prevent dangerous human interference with the climate system.

Volcker rule

The Volcker rule is a US regulation that prevents banks from making certain types of investments that contributed to the GFC. The Volcker rule is part of the Dodd-Frank Act.

World Trade Organization (WTO)

The WTO is an organisation formed in 1995 that aims to promote trade liberalisation. It operates a system of trade rules, and acts as a forum for governments to negotiate trade agreements and settle trade disputes.

World Bank

The World Bank is an international financial institution of the United Nations that provides loans to developing countries with the goal of reducing poverty.

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National Australia Bank
NHP Electrical Engineering Products
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