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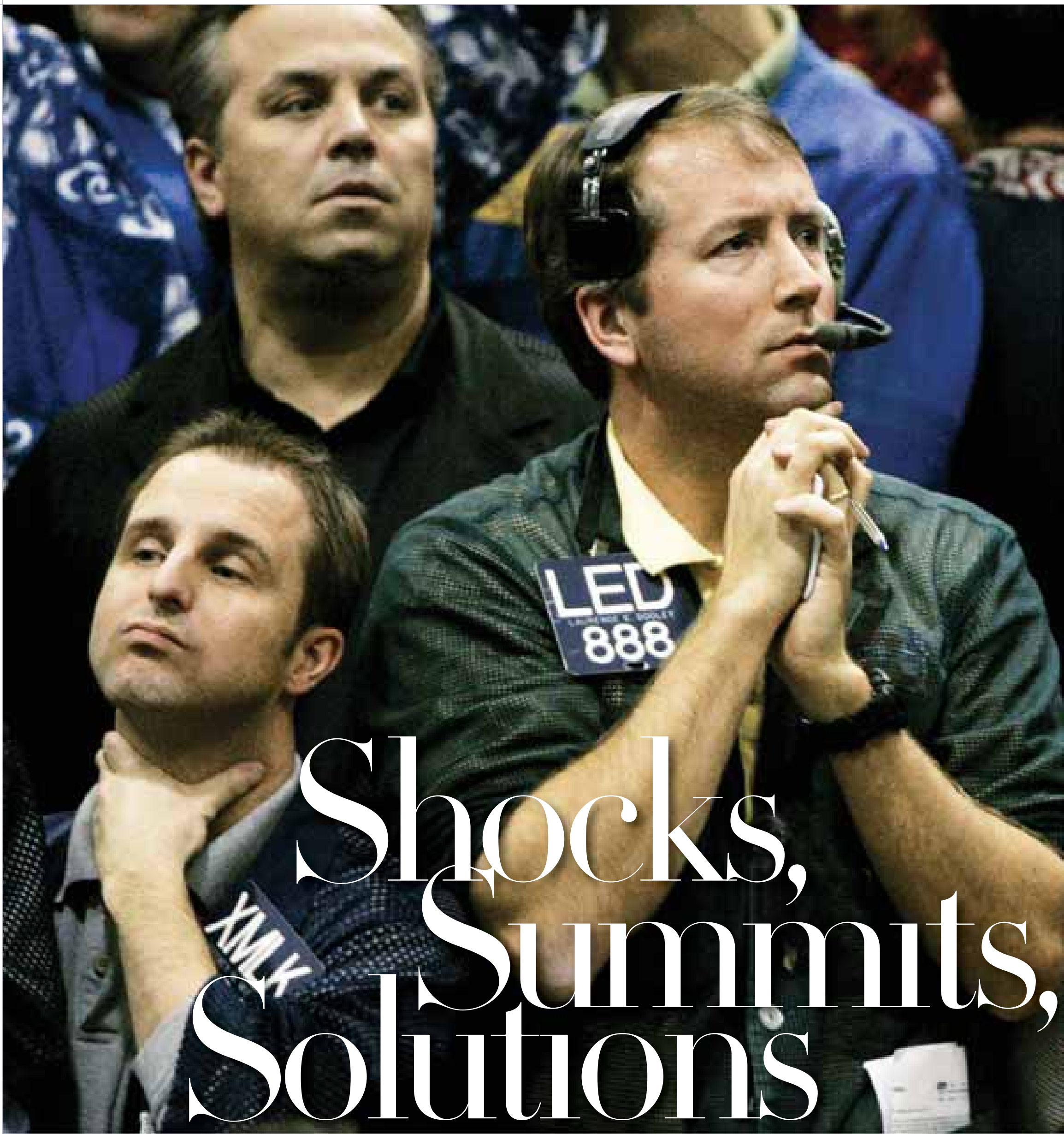

Shocks, Summits, Solutions

The global economy is teetering, just as the G8 leaders meet next month in Japan. In the west, the decade-long boom in readily-available money to borrow has turned into a credit bust, with an unexpectedly sharp vengeance. In poorer countries, rising food and fuel prices have produced riots and undone most of the benefits of increased aid to Africa. Even in China, concerns about inflation are rivalling those over Olympic protests. **Will the G8 summit rise to the economic challenge?**

Summit meetings have a strong economic pedigree. The first, held in 1975 in France, grew out of relationships forged by the French and German heads of state, Valery Giscard d'Estaing and Helmut Schmidt, while both were finance ministers. The aim of the then-G5 – the United Stares, Japan, Germany, France and Britain – was to discuss and coordinate policies among the world's five largest economies.

The backdrop to that first meeting bears an eerie resemblance to this year's summit. It took place in the wake of the 1973 oil price shock which, itself, was partly a repercussion of a war in the Middle East. Not only oil, but many commodities and food prices were soaring and inflation was rising rapidly, putting pressure on central banks. In particular, the US was urging other countries to follow its lead in cutting interest rates to ward off recession, while the German Bundesbank was strongly resisting because of its belief that inflation was the greater evil.

These conflicting pressures and the US deficit financing of its unpopular war in Vietnam led to the break-up of the Bretton Woods system of fixed exchange rates. Floating rates allowed a precipitous fall in the US dollar; a deep recession and a decade of volatile and generally rising inflation followed.

Let us hope that economic history will not repeat itself. The dollar is now at its weakest level against other leading currencies since that 1973 devaluation. The US Federal Reserve Board has cut interest rates fast and furiously since the credit crisis began last August, in an attempt to prevent a dangerous juggernaut of decline in the housing market and the financial system that holds its mortgages. The European Central Bank has kept its rate firmly where it was in August because of persistent inflation worries.

Oil prices are well above $100 per barrel, world rice prices have doubled over the past year and the World Bank claims that biofuel consumption in the west has contributed to an 83 percent rise in global grain prices. According to the International Monetary Fund's recent World Economic Outlook, the gobal economy is facing 'the largest financial shock since the Great Depression'.

JUST SEATED

The political constellation for the summit does not look promising. Five of the eight national leaders – Silvio Berlusconi, Gordon Brown, Yasuo Fukuda, Alexander Medvedev and Nicolas Sarkozy – are new in their roles and US President George Bush is a lame duck. The host, Prime Minister Fukuda, is under strong opposition pressure and some say is allowed to remain in office only to avoid the national loss of face that his ousting just before the summit would entail. Summits have yielded most success when those sitting around the table felt secure in their seats.

Recent agendas have ranged far and wide, beyond economics, depending on the state of the world and the interests of the host country. When the British organised the 2005 Summit in Gleneagles, Africa and global warming were the priority topics. Careful preparation, through then-Prime Minister Tony Blair's Commission for Africa, and his courting of other leaders during the preceeding months, led to important commitments on African aid and a process for monitoring their achievement.

By contrast, the 2006 summit in St Petersberg had little advance diplomacy and was the first not even to publish a communiqué on the world economy. Former Russian President Vladimir Putin chose to focus on energy security, education and infectious diseases. Last year's gathering in Germany was marred by a deepening rift between Russia and the west, although German Chancellor Angela Merkel's assiduous preparation and skilful negotiation was credited with shifting the US position on climate change and led her to be crowned Miss World in the German press.

To his credit, Fukuda has focused on the right issues. Two of his four main themes carry forward previous commitments on climate change and the Millennium Development Goals, especially for Africa. The other two are non-proliferation and the world economy.

ACTION PLAN

The economic sherpas preparing discussions on the world economy should highlight three areas for coordinated action: financial regulation, trade negotiations and open capital markets. All three are urgent problems which require international action.

By contrast, domestic monetary and fiscal policies can, and generally should, be directed to the specific economic circumstances of each country. At the moment, those circumstances vary widely – with the US in or close to recession, the eurozone growing moderately but facing inflation, and Japan just emerging from a long period of deflation. Attempts to coordinate interest rate policies or manage exchange rates in such divergent conditions would be both contentious and unproductive.

Financial regulation is an arcane topic mostly ignored in international forums. Yet the world's financial markets are tightly interconnected. Electronic transfers and global banking arrangements mean that money moves instantaneously around the world, around the clock. Connections among markets – for money, debt,

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shares, derivatives – as well as among countries and parties to contracts, are now so well-developed that a failure in one market, or of one financial institution, can set off a domino effect that causes multiple failures elsewhere. The US sub-prime mortgage market, which lent money for house purchases to people who might not be able to repay, is the latest example.

Without rehearsing the multiple causes and still-unfolding global consequences of the credit crunch that originated in the US, it is clear that today's piecemeal financial regulation is not up to the task of preventing such crises and spillovers. Central banks have become the guarantors, or lenders of last resort, not only for those banks 'too big to fail' but for any financial institution deemed to be 'too interconnected to fail'.

This new task is right and appropriate, but it also implies that in return, previously lightly regulated entities, such as investment banks and hedge funds, will need to come under the supervisory rule of the regulator as the quid pro quo for systemic protection from failure. Financial market failures can never be eliminated, but a new arrangement that covered all significant market players and defined the capital each required in terms of their overall exposures – both on balance sheet and off – would be a major step forward.

Many national proposals along these lines are being developed. But to promote consistent definitions and regulations internationally, and to close regulatory gaps, the G8 leaders should agree the objectives and venue for global financial regulatory reform. The Bank for International Settlements in Basle would be a good candidate to chair such talks.

The second area needing G8 attention is the Doha round of world trade negotiations. These have been stalled since last year while protectionist rhetoric has risen, particularly in the US presidential campaign. Meanwhile the growth of world trade has slowed markedly – from 8.5 percent in 2006 to 5.5 percent last year.

An agreement on liberalising trade in farm products and industrial goods is needed this summer to meet a year-end deadline to complete the Doha round. With world food prices expected to remain high, now is the time for the US, Europe and Japan to reduce subsidies to their farmers and allow set aside land to be brought back into production.

Finally, the G8 leaders need to reaffirm their support for open capital markets. While Asian investment in Citigroup, Merrill Lynch and UBS was welcomed following the credit crunch, the Committee on Foreign Investment process in the US has been used to block or deter other inward investments. European concerns about sovereign wealth funds run by prosperous nations have also grown more vocal.

Unless the capital surplus states of Asia and the Middle East are allowed to invest in other countries, the economic imbalances that have built up over the past decade will not be able to correct themselves smoothly.

Sovereign wealth funds have an attractive economic rationale for both the investing and the receiving country. By investing abroad, the investor shares the benefits from temporary oil or export bonanzas with future generations and protects the domestic economy from inflationary pressures, wasteful spending or corrupt practices. Norway, Singapore and Kuwait were the pioneers. The newer Middle Eastern and Chinese investment funds need to provide more transparency in their policies and investment allocations, but new barriers should not be erected in recipient countries without a clear rationale.

Progress in these three areas would be a major breakthrough for the global economy. Its current state is highly precarious and a confidence boost is needed. The G8 has a golden opportunity to make Hokkaido known for more than its hot springs.