

**THE ROLE OF THE G-20 IN THE GLOBAL FINANCIAL
ARCHITECTURE**

**ADDRESS TO THE LOWY INSTITUTE AND MONASH
UNIVERSITY FACULTY OF BUSINESS AND ECONOMICS**

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I would like to thank Gordon de Brouwer, Luke Yeaman and Ben Ford for their assistance in preparing this presentation.

INTRODUCTION

Thank you for the opportunity to be with you this evening. It's a particular pleasure to speak at the Lowy Institute and Monash University as we share a strong interest in Australia's international economic engagement.

In around five week's time, the Treasurer will be hosting the annual meeting of the Group of Twenty (G-20) Finance Ministers and Central Bank Governors in Melbourne. It will be the most significant gathering of its kind ever held in Australia and will put Melbourne once again at the centre of the world stage.

This meeting will be the culmination of Australia's year as chair of the G-20.

It has already been a productive year.

In response to the concern that international institutions have been insufficiently responsive to the changing structure of the global economy, the G-20 placed a priority on improving the legitimacy and credibility of the international financial institutions, especially the IMF. The G-20's advocacy of IMF quota and governance reform – making voting rights more reflective of economic developments – came to fruition at the recent IMF/World Bank Annual meetings in Singapore. At this meeting, the IMF membership agreed to a substantive realignment of IMF quotas to recognise the growing weight of emerging market economies (EMES) in the world, including key countries in our region.

Both the G-20 and Australia have, over a number of years, made an important contribution to this historic outcome. We helped build political momentum for reform, articulated the two-stage approach to reform eventually adopted by the IMF, and worked hard to build support for reform amongst other countries.

This is just one example of the G-20's work – one which has enhanced its standing as a grouping able to contribute constructively to practical international outcomes.

This evening, I would like to begin by briefly outlining some major changes occurring in the global economy, and use this to highlight the importance of international policy cooperation.

I will then focus on the features of the G-20 which mean it is well placed to fulfil this role. To put these features into context, I will briefly discuss two topical global issues on the current G-20 agenda: demographic change and resource security.

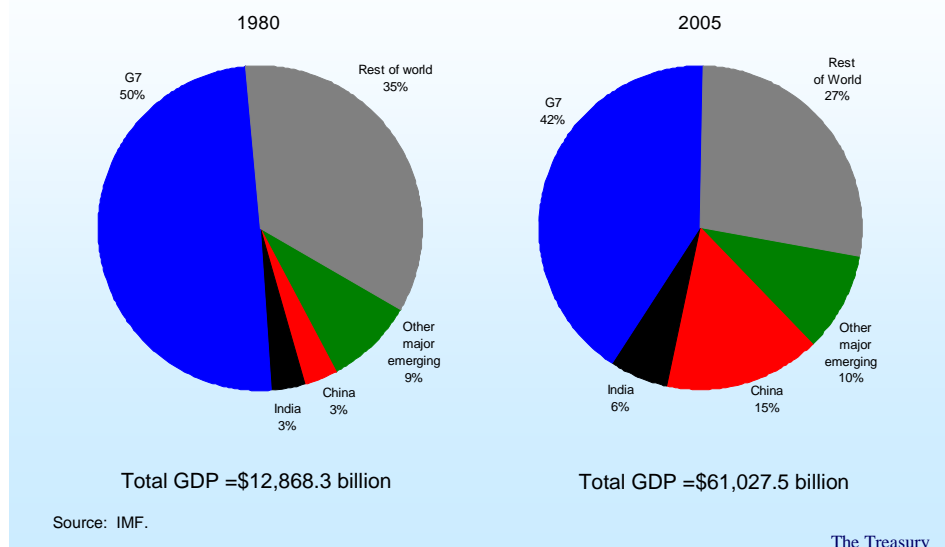
The main message I want to leave you with this evening is that the G-20 is the forum with the most potential to help address global economic challenges. It also provides a unique opportunity for Australia to help shape the direction of global economic policy, both in our host year and over the longer-term.

CHANGING ECONOMIC ENVIRONMENT

The balance of global economic activity and influence is changing rapidly.

It's worth putting these changes in some context. Chart 1 provides a breakdown of shares of global output in 1980 and 2005 measured in purchasing power parity (PPP) terms. In 1980, the G7 members – a grouping which comprises the US, Canada, the UK, Germany, France, Italy and Japan – accounted for around half of total global output. At the same time, emerging market economies accounted for around 15 per cent. Moving forward 25 years, the share of global output of emerging market economies (EMEs) has doubled to 31 per cent. While the G7 economies remain economically important, it is clear that emerging market countries have become significant players in the international economy.

Chart 1: Changing global economy
(Purchasing power parity valuation of country GDP)



While attention has tended to focus on those that have captured the popular imagination, such as China and India, we should not forget that countries such as Brazil, Mexico, South Africa, Indonesia and Saudi Arabia, are also rising in economic importance.

Moreover, the global economy has expanded significantly since 1980, with total world output (again measured in PPP terms) more than quadrupling. This means that the rise in economic weight of EMEs has not come at the expense of other countries. Rather, they have become a bigger piece of what has been a growing global pie.

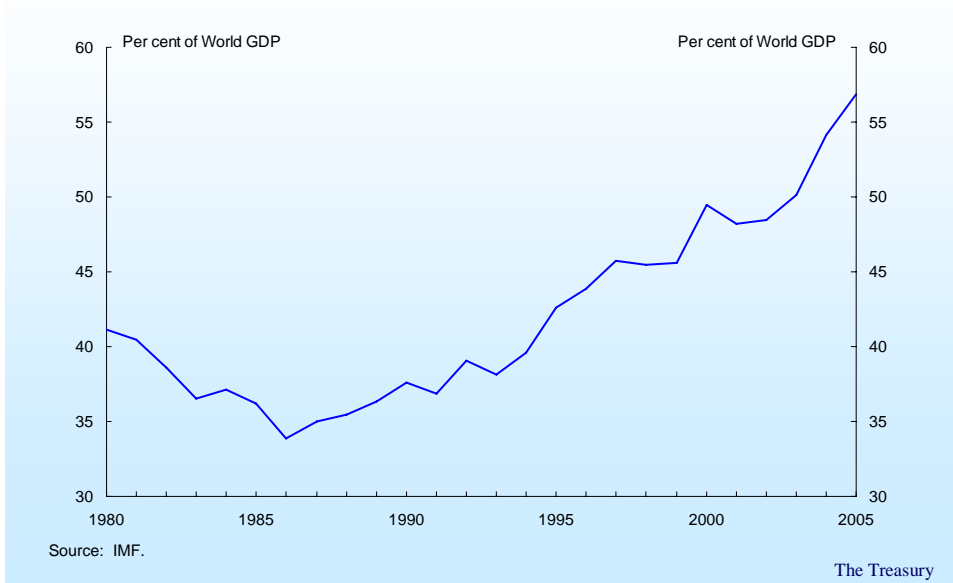
The growing economic weight of EMEs is both a consequence and a driver of the globalisation of economic activity. As many people have noted, including the Lowy Institute, the world is becoming more integrated. There has been a rapid expansion in cross-border economic activity in the past 25 years – including expanding trade and investment, broad liberalisation and deregulation of domestic markets and institutions, growth of multinational enterprises and increasing mobility of people.

The growth in international flows of goods and services can be seen in Chart 2, which shows that total world trade - defined as the total value of goods and services imports and exports as a percentage of GDP - has expanded steadily since the early 1980s, driven by the second wave of emerging economies.¹

¹ The Newly Industrialising Countries, otherwise popularly known as the Asian Tigers, being the first wave.

Chart 2: Increasing world trade

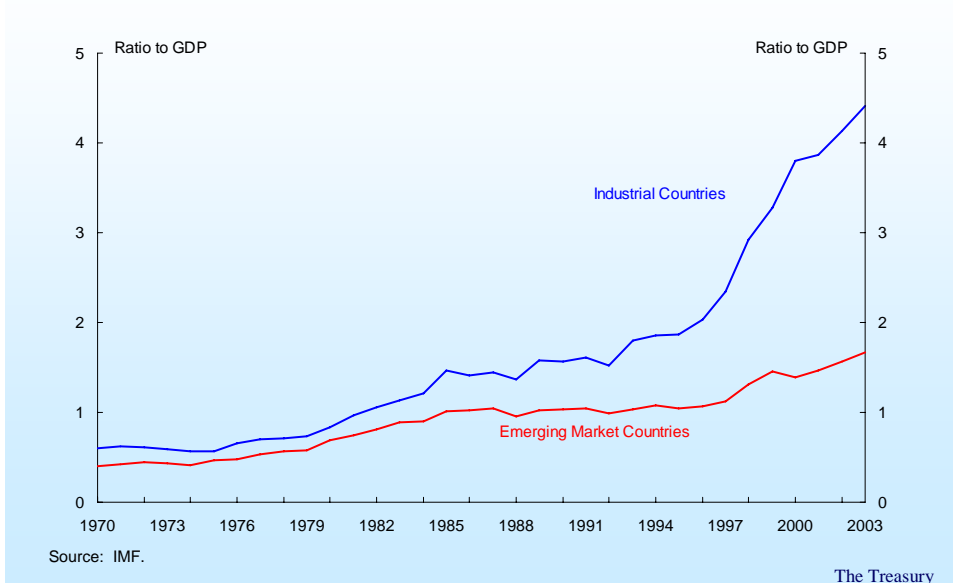
(Ratio of goods and services imports plus exports to GDP)



The growth in international financial integration can be seen in Chart 3, which shows the gross international investment position of industrialised and emerging market countries – defined as the sum of their foreign assets and liabilities as a percentage of GDP. For industrialised countries, the ratio has increased more than fivefold since 1980, while the ratio for emerging market countries, although significantly lower, has more than doubled over the same period.

Chart 3: Increasing financial integration

(Ratio of foreign assets plus liabilities to GDP)



The main message of the growth in these aggregates is that the cross-border trade and investment connections are extensive and will likely grow over time.

The growing economic weight and influence of EMEs and tighter linkages between countries means that more states have a significant stake in the international economy and, by implication, an interest in advancing solutions to global economic challenges. In this environment, international policy cooperation is essential. Indeed, it is hard to think of a global economic issue that can be successfully addressed with national policies alone or without the involvement of both industrialised and emerging market economies.

In an increasingly interdependent world, policy dialogue and cooperation can raise awareness of the impact of national policies on other countries and allow countries to learn from the experience of others that have faced, or are facing, similar challenges.

I should stress that this doesn't mean that we all need to have the same policies or cede sovereignty. What it means is that international dialogue and cooperation are an essential ingredient in effective policy making.

INSTITUTIONAL CHARACTERISTICS OF THE G-20

If we accept the need for international cooperation, why is the G-20 well-placed to facilitate this?

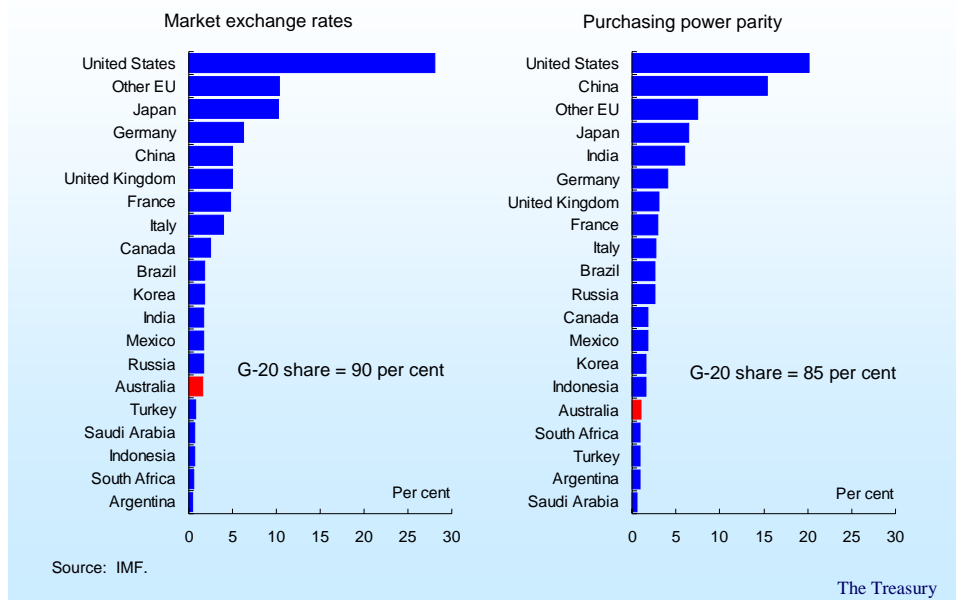
As a medium-sized, open economy dependent on access to global markets, Australia has always had a stake in the international economy and, by implication, the way in which it is governed. As such, we have been an active participant in the G-20 since its formation in 1999².

The G-20 is highly representative, comprising the world's 19 most 'systemically significant' industrial and emerging market economies plus the European Union (EU). That is, it includes all of the G7 countries (US, Canada, UK, France, Germany, Japan and

² The Group was established in 1999, in response to the financial crises of the late 1990s, with a broad mandate to address international economic, financial and development issues.

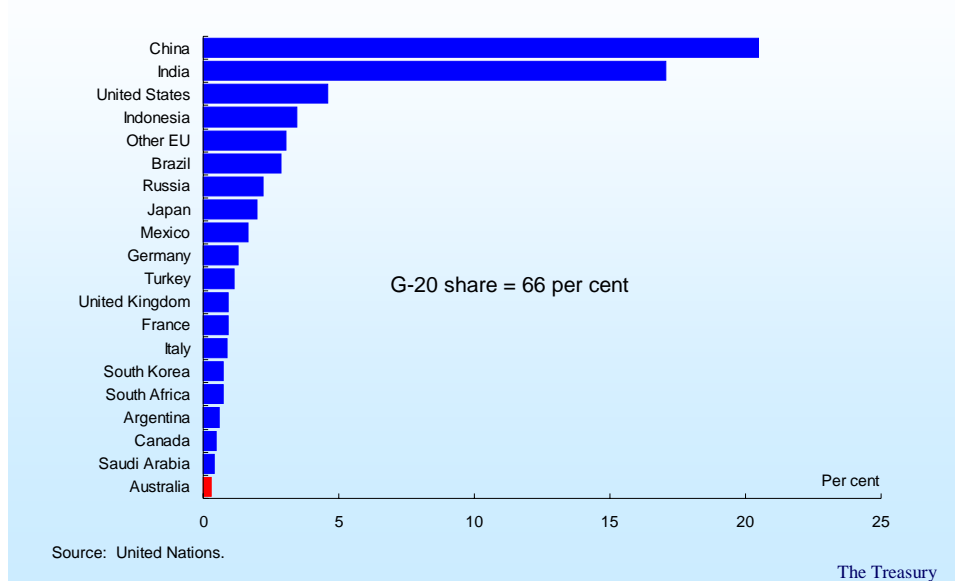
Italy) and key emerging market countries such as Russia, China, India, Brazil, Mexico, Korea, South Africa and Indonesia.

Chart 4: G-20 share of world GDP



As Chart 4 shows, the G-20 currently represents around 85 per cent of global GDP in PPP terms and around 90 per cent in market exchange rate terms. The G-20 also represents around two-thirds of the global population. Chart 5 shows (quite starkly) that any economic grouping that excludes EME's such as China, India and Indonesia, cannot claim to represent the majority of the global population.

Chart 5: G-20 share of world population



While the G-20 is highly representative, the raw numbers are just one part of the story. One of the more important features of this grouping is that it includes countries that have become more prosperous by engaging with the rest of the world.

This means that they have a significant stake in the global economy and can see the potential benefits of the G-20. Their involvement also underscores an interest in accepting greater international responsibility in line with their growing economic importance. This is one of the reasons G-20 members embraced the need for reform of the IMF – the countries that are most enmeshed in the global economy are the strongest champions of a more effective and legitimate IMF.

The G-20 also has strong links with other international fora and institutions. It includes the G7 countries, and many G-20 countries are also members of APEC and the OECD. The G-20 is also linked to the International Monetary Fund and the World Bank as both organisations are ex-officio members of the group. These linkages give the G-20 the benefit of the accumulated membership strengths of all of these forums and institutions and acts to embed the G-20 in the international financial architecture.

But these links also mean that the G-20 can use its institutional advantages – membership diversity, open and informal interaction and breadth of perspectives and experience - to act as a “circuit breaker” on issues that have reached a deadlock in other international forums.

The historic agreement to realign IMF quotas for clearly under-represented countries is a prime example of G-20's "circuit breaker" role. This remarkable achievement owes much to the pressure applied by the G-20.

Looking back, the G-20's role in achieving a commitment to new higher standards of transparency and exchange of information on tax matters to prevent harmful tax practices is another example. Looking forward, I hope the G-20 can play a similar role in the discussion of energy and mineral security.

Another feature of the G-20 that sets it apart from many other international forums is that it has no permanent secretariat. While some might view this as a challenge, it is actually an advantage, because it avoids the problem of bureaucratic capture. It also minimises the tendency to "bolt on" additional processes or sub-group meetings that distract from the main work of the forum.

The G-20 has processes which ensure a smooth transfer of functions between host countries. The management of the G-20 is shared by a 'troika' of current, past and future chairs (currently Australia, China and South Africa). While the current chair country is ultimately responsible for the policy agenda and logistical preparations for its host year, the troika ensures continuity across host years by overseeing policy development and logistical preparations³.

In addition to the management continuity provided by the troika, there is continuity in the policy themes discussed in each host year. Typically, a policy theme might be discussed over several years, providing many opportunities to get to grips with the various implications of that theme at a detailed level. An example is demographic change, which has been on the G-20 agenda since 2004. This issue has been considered from several angles, including the implications of ageing populations for domestic economic policy, the role of migration and migrant remittances from both a demographic and development perspective and, this year, the financial market implications of demographic change.

³ To manage Australia's G-20 host year activities, Treasury and the Reserve Bank have established a temporary secretariat, which is staffed by officers from both institutions.

Each G-20 host year culminates in the meeting of Finance Ministers and Central Bank Governors, usually towards the end of the year. But there are also a number of supporting meetings during the host year.

The critical point about the meeting structure for the G-20 is that discussions are underpinned by a strong analytical framework, thus ensuring they are of high quality. The framework is advanced through workshops (up to three per year), where the best thinkers from around the world address issues of importance to the G-20 with officials, and two deputies' meetings, which refine the policy issues to be discussed by Ministers and Governors. This means that Ministers and Governors are provided with contemporary analysis and insights, which better informs their consideration of policy challenges and solutions.

Those who criticise the G-20 often suggest that twenty members will result in an unworkable and bureaucratic forum. This is certainly not the case. Despite being highly diverse, the forum remains workable largely due to its institutional features.

The meetings are relatively informal, with only small delegations allowed in the meeting room; deputies' meetings are limited to a finance ministry and central bank representative and one senior official from each organisation; the G-20 meeting is limited to the minister, the governor and one senior official from each member country. This encourages frank and candid discussions unlike those often observed in other international meetings which, on the surface, appear to have an advantage in this area.

In talking up the G-20, there is a degree of self-interest, which derives from the fact that the G-20, unlike the IMF or the G7, gives Australia a permanent seat at the international economic policy table.

However, my support for a central role for the G-20 is also grounded in my strong belief that it is a more effective forum than the G7 and better suited to the emerging shape of the global economy. The periodic invitation of Brazil, Russia, India and China - the BRICs - to some G7 meetings raises their level of perceived involvement in the group but cannot match permanent involvement and still neglects other important countries such as South Africa, Korea and Mexico. I say "perceived" involvement because the invitations to the BRICs are typically limited to particular sessions or events held outside the main agenda.

Taking a long-term view, the narrow membership of current and proposed international groupings also overlooks the benefits of early engagement with emerging economic powers. Through early engagement, we can influence the direction and progress of economic development and build closer linkages with important emerging market countries. This is where the G-20 can play a major role by giving a voice to these emerging economic powers and exposing them to the types of policies pursued by successful market economies.

In contrast to existing and proposed international groupings like the G7, G4 or the G10, the G-20 represents the balance of economic influence in the 21st century and gives a genuine voice and influence to emerging market countries, while maintaining the engagement of the more established global players.

THE ROLE FOR THE G-20

I have argued that the G-20's structure and institutional features give it a unique degree of legitimacy and influence over the management of the global economy. In fact, the G-20 has already established a track record as an effective forum which promotes open and constructive dialogue that secures practical outcomes. The reform of IMF quotas I mentioned earlier is an example.

The advantages of the G-20 can also be seen in the way in which it is approaching two issues on the 2006 agenda. The first of these is **demographic change**. Australia, like many other industrialised countries, will experience major demographic change in the coming decades.

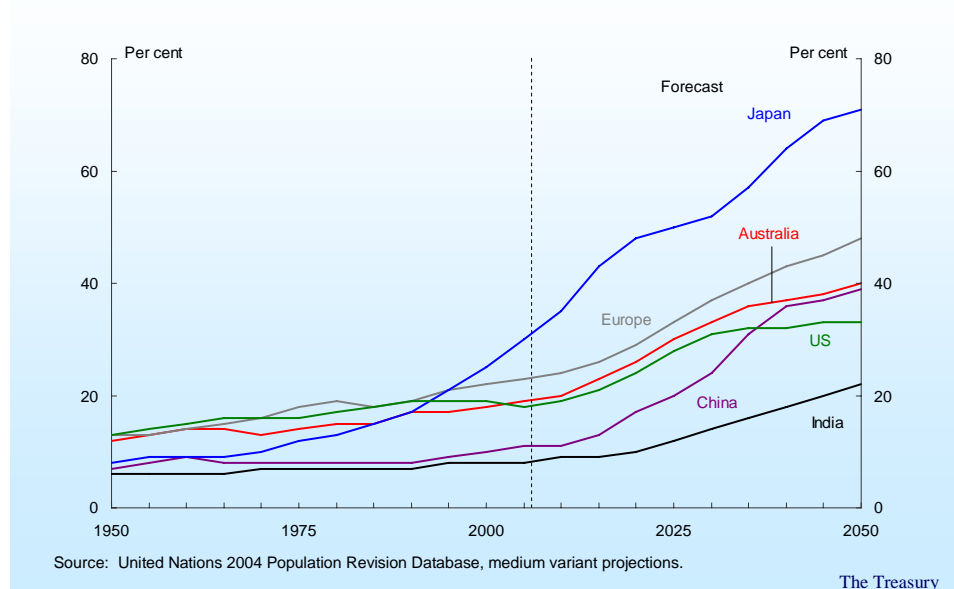
As I said earlier, demographics has been on the G-20 agenda since 2004 and the issues considered include the likely effect on economic growth, the role of migration and remittances and, this year, the implications for financial markets, institutions and systems.

The G-20's consideration of demographic change has highlighted the international dimensions of the issue. This is important because most people have tended to think of demographic change as being solely about population ageing in industrialised countries and the resultant pressures on government budgets from increased pension and health expenditures on the one hand and slower growth in tax revenues on the other.

However, demographic change, and the responses to it, aren't just confined to population ageing in industrialised countries. Different countries are at very different stages of demographic transition. It's true that in most advanced economies the process of population ageing is already well-advanced and, as can be seen in Chart 6, there is expected to be a sharp rise in the old-age dependency ratio – which is the ratio of retirement age people to those of working age. In many advanced economies, working age populations are barely growing and in some they are already declining. But, in many developing and emerging market countries the transition is still at an early stage and working-age populations are likely to continue to grow for some time, in some cases quite rapidly.

Chart 6: Old-age dependency ratios

(Ratio of 65+ year olds to 15-64 year olds)



This presents a very different set of challenges and opportunities. If these challenges are not managed effectively they will affect all countries in the global economy.

Countries with relatively younger populations may be able to benefit from strong population growth. However, the ability of developing and emerging market countries to harness the benefits of increasing working-age populations depends heavily on the domestic macroeconomic and policy environment. The G-20, through the *Accord for Sustained Growth*, can assist in helping these countries to implement suitable policies and can pass on lessons to help them avoid some of the mistakes of industrialised countries.

The *G-20 Accord for Sustained Growth* was developed in 2004, and outlines the G-20's view about the critical elements of best practice economic policy making. It highlights the importance of domestic institutions, good governance, sound structural policies and stable macroeconomic frameworks.

The optimal response to population ageing also has international dimensions. For example, capital and labour flows between older developed regions and younger developing regions could assist countries in dealing with the impact of ageing by providing new investment and employment opportunities.

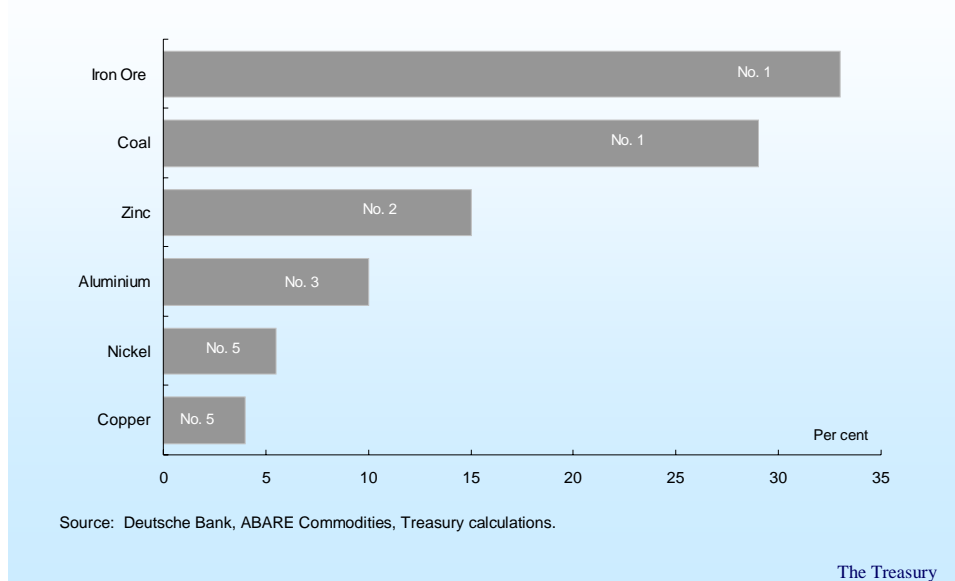
But there are significant barriers to cross-border capital and labour flows. This highlights the need for international policy dialogue and cooperation. Since the G-20 brings all the major population centres to the table, it can play a crucial role in highlighting how to improve the policy environment and address some of the impediments to international capital and labour flows.

Another global issue of interest to the G-20 is that of **resource security**, which will be discussed under the theme of global energy and minerals markets.

This discussion is intertwined with the economic changes I highlighted earlier - rapid industrialisation in China and other emerging market economies – as well as strong growth in the world economy - has boosted demand for a range of energy and mineral commodities, squeezing spare production capacity and raising prices.

These developments have been important for Australia, particularly given our significant role in satisfying the growing global demand for energy and minerals. As can be seen in Chart 7, Australia is the leading exporter of iron ore and coal and in the top five globally for zinc, aluminium, nickel and copper.

Chart 7: Australian resource exports
(Proportion of total world exports)



There are some clear macroeconomic implications of these developments, including their potential affect on inflation and global economic activity. However, at a deeper level, these developments have also generated concerns about resource security, concerns which have, at times, been expressed or perceived as threats to national interests. This explains why the issue can sometimes be viewed through a strategic prism, which results in policy prescriptions that focus on rushing to lock up and monopolise available energy and mineral resources.

These policies are unlikely to be effective in delivering greater resource security over the long-term. Geo-strategic decisions are influenced by considerations outside the economic and financial criteria we are familiar with, such as efficiency. This is an oversight that can see commercially suspect projects pursued at the expense of other more sensible alternatives.

The solution to securing a stable and predictable supply need not be a zero-sum strategic game. Open and well-functioning global markets can deliver resource security without generating these problems

One of the key messages we hope to see emerge from the G-20 discussion this year is that market-based approaches can help address a range of policy challenges, including delivering greater resource security.

The G-20 is an ideal forum for this discussion as it brings together the key resource producers such as Saudi Arabia, Russia, Australia, Brazil, Canada and South Africa and the main consumers, including the key growth consumers China and India.

The G-20 is also well-suited to this kind of discussion since, through the *G-20 Accord for Sustained Growth*, the membership has explicitly recognised the importance of policy frameworks that support the operation of markets.

At its most basic level, the discussion will be about ensuring that the minimum standards of transparency and governance are in place to allow capital and expertise to flow to resource-rich areas, wherever they may be. For example, this may involve G-20 endorsement of the sorts of governance principles embodied in the Extractive Industries Transparency Initiative.

At a more advanced level, we will be discussing how to address some of the clear impediments to the operation of global markets, including distortions from various taxes and subsidies and various forms of restriction on investment.

THE 2006 G-20 AGENDA

While I have touched on a few of the issues the G-20 will be discussing in 2006, it is worth putting them in the context of the complete 2006 agenda [chart 8].

Chart 8: Building and sustaining prosperity Australia's 2006 G-20 policy agenda

- Reform of the Bretton Woods Institutions
 - Global energy and minerals markets
 - Addressing demographic challenges
 - Global macroeconomic conditions
 - Political economy of reform
- * * * * *
- Aid effectiveness

The Treasury

The overarching theme for 2006 is 'Building and Sustaining Prosperity', under which sit five policy themes. I have already discussed three of these themes tonight: reform of the IMF and World Bank, demographic change and global energy and minerals markets.

The G-20 meeting will also include a session reviewing current developments and risks in the world economy. This session is likely to focus on the challenges facing the operation of monetary and fiscal policy given the significant reduction in global spare capacity and high global energy and minerals prices over recent years.

The meeting will also continue the dialogue on the *G-20 Accord for Sustained Growth* through a discussion of the politics of reform, identifying practical ways for governments to implement and build public consensus for reform. The unique feature of this discussion will be its focus on the "how" of economic reform rather than the "why", a distinction which reminds us that reform is often a battle for hearts and minds rather than a technocratic exercise.

I would emphasise that within all of these policy themes, the implications for development are front and centre. This is important – the G-20 does not see development *per se* as a topic that is sensibly considered in isolation. We do, however, focus on particular aspects of development at different times. For example, following last years annual meeting in

China we issued a *G-20 Statement on Global Development Issues*, and the quantum of official development assistance and the effectiveness of aid are both live issues.

CONCLUSION

To sum up, I believe the G-20 has a key role in shaping global economic policy.

The case for the G-20 reflects the dramatic changes in the world in the last half-century. These changes have seen the emergence of new economic players and increased the links between countries. In this new economic landscape, no country can remain an island. All countries have a significant stake in the international economy.

However, most of the institutions we have traditionally relied on to facilitate global economic policy dialogue and cooperation have not adjusted to the global economic changes I have described this evening.

In contrast to many of the more mature international forums, the G-20 brings together the key global economic players of the 21st century and is structured to encourage open and effective policy dialogue. The fact that its agenda can be shaped by, and the group chaired by, China, Australia, South Africa and a (yet to be determined) South American⁴ economy in a given four-year period is testament to the changing global and economic power distribution.

While the G-20 has made a substantial contribution to the recent success in Singapore, the advantages of the G-20 can also be seen in the way it is approaching two topical global issues which are currently on the 2006 agenda: demographic change and resource security.

On these, and other important global issues, the G-20 will continue to push for comprehensive and effective international solutions.

I hope you will continue to support the development of the G-20 and follow the discussions with interest.

Thank you.

⁴ The 2008 chair is expected to be drawn from Argentina, Brazil or Mexico.