Executive summary

The London Summit

On 2 April 2009, world leaders from the G20 countries – representing 85% of the world's output – will meet in London. They will meet against the backdrop of the worst international banking crisis in generations. Confidence in the international banking system has fallen. Major institutions have failed. Countries around the world have entered recession, with falling trade and rising unemployment.

Governments have had to step in where markets failed. Like countries around the world, the UK Government has taken unprecedented action. Its plan for recovery has four pillars: to protect savings; to provide real help for families and businesses in the downturn; to ensure that banks maintain lending; and to invest in a resilient recovery and prepare the country to take the opportunities of globalisation and low-carbon growth.

At the Summit, countries need to come together to enhance global coordination in order to help restore global economic growth. World leaders must make three commitments:

- First, to take whatever action is necessary to stabilise financial markets and enable families and businesses to get through the recession.
- Second, to reform and strengthen the global financial and economic system to restore confidence and trust.
- Third, to put the global economy on track for sustainable growth.

The crisis unfolds

The financial crisis broke in summer 2007 against a backdrop of strong economic growth, low inflation and low unemployment.

Subprime risks trigger market freeze

There had been a rapid growth in the number of subprime mortgages in the US – mortgages that offered low initial interest rates to borrowers with poor credit histories. However, many borrowers were unable to afford their repayments.

Mortgage defaults rose and house prices started to fall. Holders of mortgage-backed securities – loans that banks had packaged up and subsequently sold – started to question their exposure to this increased risk of default. Investors found that they were unable to quantify the value and risk of these increasingly complex products.

The market for these assets effectively closed down. They could only be sold at fire-sale prices, far below their long-term economic value. Banks had assumed that liquidity would always be available – however, this was no longer the case.

Over summer 2007 a number of institutions failed. Banks that had become reliant on short-term funding from the money markets – such as Northern Rock – suddenly found that their business models were no longer viable.

As a result of this uncertainty, banks hoarded liquid assets and the cost of lending between banks rose sharply. At the same time, central banks were constrained in their ability to react by the inflationary pressures of the concurrent surge in oil and food prices.

Concerns about solvency
As the banks uncovered losses, concerns grew. These increased as banks started to bring off-balance-sheet lending back onto their books. What started as a liquidity crisis – difficulty with funding day-to-day operations – evolved into a wider issue over the solvency of the banking system.

The International Monetary Fund (IMF) estimated that the majority of the losses had still to be realised – and could reach over $2tn in the US alone. The growth in securitisation meant that it was difficult to identify who would ultimately bear these losses. As a result, banks remained unwilling to lend to each other and the inter-bank lending rate remained high.

Collapse in confidence
The failure of Lehman Brothers in September 2008 led to a collapse in confidence in the wider banking sector across the globe. Financial institutions were exposed through their greatly enhanced leverage and the complex network of bilateral contracts.

Investors shunned all forms of risk. Together with growing concerns over economic growth, this led to a fall in the price of many assets, in particular equities and corporate bonds. This brought the fragile global financial system to the brink of collapse.

Impact on the wider economy

The global economy was growing strongly when the subprime crisis hit. In the UK, the economy was close to trend, inflation was close to target, public sector debt was relatively low and unemployment remained low.

The US economy was the first to slow, but the crisis quickly spread to other advanced economies. By mid-2008 many advanced economies were in recession. Emerging markets, through a combination of buoyant trade and high commodity prices, appeared to be relatively resilient.

However, the events of September 2008 led to a wider collapse in confidence. This has fed through into sharp falls in trade, production and investment around the world. As economic activity has slowed, unemployment has risen and inflation fallen.

Over the last year – due to the complexity and uncertainties of the global crisis – international forecasts of economic growth have been continually revised downwards. Countries initially not affected by the problems in the financial markets have been hit through the impact of falling activity on international trade. The latest IMF *World Economic Outlook* for 2009 forecasts world economic growth will be at its lowest rate since the Second World War.

Banks continue to uncover further losses that need to be met by additional capital. However, the collapse in the market value of the banking sector makes it increasingly difficult to raise this capital from the private sector. As a result there is a risk that, unaided, banks will cut lending to businesses and families. The challenge is to limit the impact of these pressures on the wider economy.

Context of the global financial crisis

Globalisation has delivered significant benefits over recent decades. Consumers have a wider choice of goods and services, prices have fallen, productivity has increased and millions have been lifted out of poverty. However, globalisation also brings challenges such as climate change, unequal growth and widespread exposure to financial crises.

Increased global financial integration has enabled record financial flows. Firms are increasingly able to access capital from across the world. Investors are no longer limited to investing in domestic markets.

The US and some European countries responded to the significant increase in the world labour force (as large emerging markets became integrated into the global economy) with increased consumption and investment. As a result they ran large current account deficits, financed by external borrowing. At the same time, as many Asian economies expanded, these economies saved more than they invested domestically and, coupled with export-led growth strategies, generated surpluses that were invested abroad.

The search for yield

The entry of China, India and other emerging countries into the global trading system increased the global labour supply, increasing world trade and the supply of low-price goods. This change had a powerful disinflationary effect.

Low inflation coupled with record financial flows helped contribute to low interest rates across the world and pushed down returns in traditional assets. As yields across a range of assets fell, banks looked for new ways to increase their returns – the 'search for yield'. This search sparked a wave of financial innovation.

Rather than relying on traditional retail deposits, banks increasingly used the wholesale money markets to provide funding. There was a dramatic increase in the use of complex forms of securitisation – where loans are packaged up and sold to third parties.

These new ways of working loosened the traditional limits on banks' balance sheets. Banks had less incentive to apply as stringent credit checks on borrowers. As a result, banks were able to significantly increase lending volumes. Leverage – the ratio of lending to capital – dramatically increased.

In addition, banks – in a search for higher returns – started to trade and hold these structured products off-balance-sheet, thereby releasing capital to allow them to increase lending further.

Impact of financial innovation

Increased levels of lending and securitisation left banks exposed as the crisis unfolded. Complex securitisation reduced transparency. Banks were less worried about credit risk as the loans were subsequently sold on to third parties. Little or no account was taken of low-probability, high-impact events by the external credit rating agencies – on which investors increasingly relied.

Two-thirds of the growth in lending over the last decade was within the financial system, rather than the wider economy. In addition, it is apparent that the pay structure within banks encouraged short-term revenue generation, with little regard for the longer-term risks this could create. This combined with over-exuberance to perpetuate risks – at a cost to consumers and the resilience of the wider system. Coupled with strict conditions on those banks receiving Government support, the UK has set up a review of banks' corporate governance to learn the lessons from these events.

Regulators around the world had not fully taken account of financial innovation and the rise of off-balance-sheet vehicles. Insufficient focus was given to the liquidity risks faced from increased reliance on wholesale funding. Increased trading between banks left the system over-leveraged, more interdependent and therefore less resilient to shocks. These systemic risks have significant implications, and demonstrate the need for stronger international coordination.

Overall, the regulatory framework had arguably become 'pro-cyclical' – encouraging excessive lending in the 'good times'. The UK Government has asked Lord Turner to consider what reforms need to be made to financial regulation.

The UK response

The global financial crisis has required unprecedented action from governments, central banks and regulatory authorities across the world. Governments have stepped in where markets have failed.

The UK plan for recovery has four pillars:

1. Protecting people and their savings by preventing the collapse of the banking system.

2. Giving real help to families and businesses now to support the economy.

3. Supporting bank lending to families and businesses.

4. Investing for recovery and preparing the country for the new opportunities and challenges of globalisation.

Financial instability has the potential to affect families and businesses far beyond the banking sector. It is important to prevent an abrupt reduction in credit. It is needed to fund investment, the day-to-day costs of businesses and purchases by families. The best way to protect jobs and prosperity is to maintain the level of credit.

Protecting people and their savings by preventing the collapse of the banking system by:

- **Providing temporary liquidity:** Countries around the world have provided liquidity to their banking sectors. The Bank of England has made £185bn available to allow banks to swap illiquid financial assets with highly liquid Treasury bills. Up to £250bn is available to guarantee lending to banks to refinance funding from wholesale money markets.

- **Protecting depositors by supporting individual banks:** When confidence in Northern Rock was lost, the UK Government acted to guarantee deposits and take it into temporary public ownership. The level of depositor protection has now been increased. Other countries have also intervened to rescue or restructure individual banks.

- **Recapitalising the banks in return for shares:** The UK Government made £37bn of new capital available to banks in return for an equity share. This reduced their risk of insolvency and helped to restore confidence in the financial system. Globally, nearly $500bn has been announced for recapitalisation.

Giving real help to families and businesses now to support the economy

- **Stimulating demand through lower interest rates:** Monetary authorities across the world have significantly cut interest rates in order to support demand. Falling inflation will provide support for living standards for those in work or on fixed incomes. The monetary policy framework has enabled the Bank of England to reduce the base rate to a record low of 1.0%. The US Federal Reserve has cut interest rates by over five percentage points to effectively zero.

- **Providing a fiscal stimulus:** The UK Government has provided a £20bn stimulus to help mitigate the impact of the downturn. Measures include a cut in VAT and increased support for pensioners and children. It is targeted, timely and temporary – and so will not compromise medium-term sustainability. Most G20 countries have announced stimulus packages, most recently with the US $787bn stimulus, with injections estimated at over $2tn into the world economy.

- **Providing direct support for households and businesses:** The UK is also implementing a range of targeted measures to provide real help to those feeling the impact of the financial crisis. This includes help for homeowners and those facing redundancy, and maintaining access to funding for businesses and providing direct support for the car industry. Other countries are implementing similar packages, including support for car industries in the US, Canada and a number of European countries, unemployment support in Japan, increases in social security in Mexico and loan packages for Brazilian industry.

Supporting bank lending to families and businesses by:

- **Reducing uncertainty through asset protection:** Governments are considering how best to reduce the continuing uncertainty about the value of banks' past investments, so providing them with greater confidence to lend in the future to creditworthy businesses, homeowners and consumers. One aspect of the UK Government response is to protect banks against losses in return for a fee. Other countries have been dealing with impaired assets at individual banks, and are proposing similar options of asset and capital insurance and so-called 'good bank – bad banks' proposals.

- **Providing support for business lending:** The Bank of England has been authorised to purchase up to £50bn of high-quality private sector assets. This will help to increase the availability of corporate credit and improve liquidity within the market. We have supported £21bn of loans to small- and medium-sized businesses.

Investing for recovery and preparing the country to take advantage of the opportunities of globalisation:
The UK Government is also putting in place the foundations for a balanced recovery including taking advantage of new and expanding export markets. The economy cannot go back to 'business as usual'. Governments want to build a resilient recovery that offers stable, sustainable and low-carbon growth. As a result of these decisions, the UK's economy will emerge stronger and more competitive, with the following in place:

- A stronger, more responsible, more resilient financial sector with more effective governance. Tougher, smarter regulation will address the weaknesses identified over the last two years, but without undermining the sector's role in supporting investment.

- A new drive to cement Britain's place at the heart of the global trading system. This will build on the strong increase in competitiveness seen over the last year, the highly skilled international talent base and UK Trade & Investment's work to strengthen our export performance in emerging markets and our openness to inward investment.

- A commitment to ensuring that the UK workforce has the skills it will need to take advantage of the opportunities of an increasingly globalised world, through a high-quality education system and the provision of lifelong learning.

- A new focus – backed by investment in skills, research and national infrastructure – on vital knowledge-based sectors of the future such as the low-carbon, digital, bioscience and creative industries, and education. This will build on the world-class businesses that we already have in key sectors such as advanced manufacturing, defence and security, pharmaceuticals, insurance and energy.

- A continued commitment to medium term macroeconomic stability built on low inflation and sustainable public finances.

- Investment in low-carbon infrastructure, which will not only tackle climate change but will also create incentives for firms to invest and new opportunities to support the move to a low-carbon economy. The UK and other countries are advocating a low-carbon recovery including: major investments in energy efficiency; a shift to renewables; research and development including the commercialisation of low-carbon cars; and the skilled workforces that these sectors need.

The London Summit

At the London Summit, governments and International Financial Institutions will come together to agree the need for a comprehensive package of measures, coordinated globally, to address the causes and consequences of the crisis. By working together, and coordinating their actions, each country will maximise the impact for themselves and each other.

The macrofinancial response

Further steps are required to stimulate global demand. At the London Summit, world leaders will:

- review the following: the global impact of the financial crisis and whether further action may be warranted; how to ensure that the imperative to boost demand immediately is consistent with the need for long-term fiscal sustainability; and how to maintain levels of public investment, both in physical and human capital;
- reaffirm their commitment to price stability and to avoiding deflation, and support central banks to continue to take the necessary monetary policy measures; and
- reaffirm their determination to take whatever action is necessary to ensure the stability of the global financial system, including immediate action to support lending, and considering the case for cooperation on dealing with impaired assets.

The role of the International Financial Institutions

At the London Summit, world leaders will identify whether:

- the IMF's resources should urgently be increased so that it can increase its lending capacity to prevent crises, address damaged financial systems and help stimulate demand;
- to strengthen the IMF's early warning and surveillance function and reform its governance structures;
- the Multilateral Development Banks can increase their support for trade credit in the developing world;
- the Multilateral Development Banks can make better use of existing resources to support global demand and increase their focus on the poorest; and
- to speed up the strengthening of the IMF and World Bank's governance structures.

Reshaping the global financial system

At the London Summit, world leaders will consider how governments and regulators can:

- work together internationally to agree what further steps are needed to enhance corporate governance and risk management by financial institutions;
- agree steps to strengthen prudential regulation, including requiring banks to build buffers of resources in good times;
- manage the transition through the current downturn to a new equilibrium, with strengthened prudential standards so as to ensure that regulatory regimes do not act pro-cyclically, exacerbating the current downturn;

- ensure that financial activities are regulated according to their economic substance rather than their legal form and regulated consistently in all jurisdictions; and
- ensure that regulatory regimes are better prepared for failure within financial markets.

In addition, world leaders at the London Summit will review whether further steps are needed to marry better the objectives of financial and macroeconomic stability.

Putting the world economy on track for sustainable growth
At the London Summit, world leaders should:

- call for an early completion of the current global trade negotiations, the Doha Round, and strengthen the commitment made in Washington to refrain from measures that are protectionist, either in intention or in effect, and put in place transparent mechanisms to monitor such commitments;
- discuss how to ensure that everyone has the skills they need for the jobs of the future;
- call for a low-carbon recovery, and agree the need for international leadership on a strategic framework to stimulate investment; and
- reaffirm their commitment to the Millennium Development Goals and commit to making the necessary investments, including honouring their previous commitments to increase development assistance.

The Global Deal

The world's leading economies can come together to agree a package of internationally coordinated measures to restore stability and set a course for a sustainable recovery, including:

- review the global impact and effectiveness of measures taken so far to **stimulate global demand** both by national authorities and by the global financial institutions, and consider the implications for the future;

- immediate action to substantially **increase the IMF's resources** so that it can increase its lending capacity to support countries suffering from reductions in capital flows, supporting the objective of stimulating demand;

- immediate action consistent across countries and with clear exit strategies to support domestic and international **lending** by ensuring that banks are adequately capitalised and can raise the funds needed by dealing with banks' impaired assets and, where appropriate, through direct government or central bank lending;

- all countries to **renounce protectionism**, with a transparent mechanism to monitor commitments and measures to increase access to trade finance;

- **reform of financial regulation** – closing regulatory gaps, enhancing corporate governance and coordinating regulation of global financial markets in order to create a global financial sector that serves the needs of the wider economy;

- **an international early warning system**, with a strengthened role for the IMF in order to help promote balanced growth;

- **reform of the International Financial Institutions**, increasing their resources, encouraging greater access to IMF resources, and strengthening the voice and participation of emerging and developing countries; and

- **honour commitments to increase development assistance**, to protect the poorest from the impact of the crisis.