Regional ‘Think 20’ Seminar

Session 3: Reforming the International Financial Architecture

International Monetary System Reform and the G20

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Introduction

Discussions about the problems and reform of the international monetary system (IMS) have been intensified since the 2008 global financial crisis (IMF 2011). However, there has been little consensus among academics and policy makers on desirable path for reform, or even whether the reform is necessary or not. As a consequence, there has not been much concrete accomplishment so far.

The current IMS has survived for over forty years, underpinning strong growth in GDP, international trade and capital flows. But the system also revealed many symptoms of instability—frequent crisis, persistent current account imbalances and exchange rate misalignments, volatile capital flows and currencies, and unprecedentedly large reserve accumulation centered in the US dollar (IMF 2011). In fact, the current IMS is something of a “non-system”. After the collapse of the Bretton Woods system in 1971, the world has divided into two camps – one with major currencies that float freely and permit free flows of capital, and one with varying degrees of control over exchange rates and cross-border flows (Mateos y Lago et al. 2010). The current IMS does not have any established mechanism to facilitate the adjustment of global imbalances, and so they persist, becoming a source of increased uncertainty and instability.

Given these problems, there have been various proposals to reform the current IMS. These include proposals to build stronger global financial safety net, to
diversify the supply of global reserve currency and so son (Cho 2010, IMF 2010, 2011, Subacchi and Driffil 2010). However, there also have been arguments that although the current system is not an ideal one, it is hard to find a better alternative given the political and economic reality in the current world (Truman 2010). Some other arguments have been that flaws in the IMS had little to do with the global financial crisis directly.

**Discussions and Progress through the G20 Process**

The discussion and the reform efforts through the G20 process has been concentrated on strengthening policy collaboration; global financial safety net; monitoring and management of capital flows; surveillance of global economy and financial system; and reserve assets and reserve currencies.

*Regarding policy collaboration*, the establishment of MAP is a progress. But the G20 so far has failed to establish the specifics of the modality of the MAP. The G20 has not delivered, as part of its Framework for Strong, Sustainable, and Balanced Growth, and the associated MAP, a set of specific, quantified, and verifiable policy commitments through transparent process yet. No clear obligations and responsibilities have been agreed, except leaving them to peer pressure of member countries.

*Regarding global financial safety net*, some progress has been made by establishing new lending facilities of the IMF (FCL, PCL, PLL) and increasing the IMF resources. However, little progress has been made in linking the IMF and regional financial arrangements such as CMIA, EFSF and ESM. Institutionalization of swap arrangements among central banks, which would possibly be the most effective global financial safety net, has been failed. This is an area which deserves further G20 efforts.

*On capital flows*, renewed attention has been made on inflows as well as outflows and on the policies of source countries as well as destination countries. While these efforts have not produced full agreement, they have contributed to greater consensus that has emerged over the last four years and produced a set of
“coherent conclusions for management of capital flows drawing on country experiences.” (Truman 2011) The conclusions are not binding on countries and do not limit national policy choices. But it became clear that EMEs can now adopt temporary measures more freely to control capital flows than before, of course, in the relevant broad policy context when they are deemed to be necessary.

On reserve asset and reserve currencies, the discussions have not produced any tangible outcome, except the allocation of greater amount of SDR. This is not surprising because the dollar’s role as an international currency is dominated by decisions private sector actors and institutions rather than public decision. And also because, there would be a limit in the effort to promote SDR as a replacement for the dollar as reserve assets and as an international currency (Park and Wyplosz 2011, Truman 2011)

**Historical Experiences**

Throughout the history, the evolution of the IMS has been shaped not only by the experiences of the previous systems but also by the dominant economic thoughts, balance of economic weights, and political economy of the time. The dominant reserve currency changed with the shift of economic power, but only after a substantial time lag. In the initial stage of these changes, the dominant country was always reluctant to accept changes and push reforms, while the emerging power was hesitant to accept greater responsibility as a reserve issuer. As a result, there was no drastic change, but only gradual and incremental change.

The shift from pound to the dollar and the elimination of pound as a major international currency resulted in periodic crises, international tensions, and conflict over the United Kingdom’s domestic economic policy. In short, although it was not a painless transformation, it was still tempered by the international commitment to avoid a damaging tipping point for pound that would have undermined confidence in the IMS as a whole (Schenk 2010).

The transition this century would likewise require close collaboration among the
major players – incumbent and emerging powers – to avoid turbulence and severe instability in the international financial system. The shape of the IMS in the 21st century will be significantly influenced by the views, interests, and requirements of the emerging powers.

**Current Option**

But given the current international political and economic reality, it is hard to expect a major progress in IMS reform would be made in the near future. The best alternative would be strengthening the role of the IMF in its systemic liquidity provision and surveillance; and strengthening policy collaboration through the G20 process. For this, the effectiveness of the G20 as a global governance forum should be enhanced, and greater involvement of the IMF in the G20’s MAP would be needed.

The role of the IMF has been changing in responding to the crisis, pushing early on for economic stimulus, helping coordinate policies, providing financial resources, supporting the G-20 with analysis, and in IMS reform. Now, the challenge is to go further, including a greater focus on financial sector issues and more generally enhancing the effectiveness of its bilateral and multilateral surveillance. It should earn more trust among EMEs by showing its political independence from the US and major European countries. In order to become more effective in surveillance, not only the greater involvement in the G20 process but also more credible and independent analysis of its reports would be essential.

Enhanced surveillance by the IMF would mean increased IMF interventions in member countries’ economic policies. However, unless changed from previous practice – one dominated by the traditional powers – it would be regarded by most EMEs as a worse outcome. Hence the most important element of IMF reform is change to its governance structure.

There has been widely shared criticism that in the past the IMF has been used as an instrument for industrial nations to achieve their policy objectives. It bailed out
creditors of industrial countries and imposed very costly adjustment programs on debtor countries. Mistrust in the IMF is in part due to the perception that its surveillance has been asymmetric, with greatest attention paid to the weaker developing states or those in deficit, while the major deficit and surplus countries, including the US and China, are given too much leeway. Further efforts are needed in order to establish trust among all its member countries, and this can be done most effectively through rebalancing of the governance/management structure of the institution.

There are two major problems with present governance arrangements: the composition and voting structure of the board, and the appointment of management and those at senior positions. The board is too heavily weighted toward industrial countries, especially in Europe, and it fails to give sufficient weight to EMEs and developing countries, which are of course seriously affected by its decisions. Currently, the quota share of advanced economies is more than 60% (US 17.7%, Europe 31%). EMEs and developing countries’ share is 39.5%. Europe’s voice can be potentially much bigger than this figure suggests, due to the current composition of the executive board.

At the G20 Seoul Summit it was agreed that 6% of the quota share would be transferred from European to emerging market economies, though the formula to achieve this has not been fully sorted out. It was also agreed that two seats of the executive board currently occupied by Europe would be transferred to EMEs. However, these two measures would not change the governance structure significantly – the US and Western Europe would still dominate decision making through various rules (including the “85% rule” and the veto power of the US) and through the composition of the executive board. Although the quota of EMEs would be increased, the Board and decision making of the IMF still would be dominated by advanced economies, i.e., the US and Europe.

The governance structure should be more radically changed, for without it, the IMF risks becoming marginalized as an agent solely for a group of industrial countries. There is a large asymmetry between the governance structures of G20
and the IMF. Ideally, the formula for IMF quota reallocation should give emerging economic powers more representation than their current economic weight (which is based on nominal GDP) justifies. However, as this would be difficult to implement in reality, other measures would have to be sought. One way would be a reconfiguration of the composition of the board of directors, cutting the number of European seats – a single Eurozone seat could be an option.

Another way would be to have the G20 finance ministers meeting as a steering committee for IMF governance, determining the direction of major policy issues. If the G20 became a decision-making ministerial body within the IMF itself, it would reduce the asymmetry both between global economic governance forums and the governance structure of the IMF. This would also help reassert the centrality of the IMF’s role as a key institution in IMS. This proposal has been featured in a recent advisory report to the IMF Managing Director (the “Fourth Pillar” report) and has been put forward by a number people, including Mervyn King, governor of the Bank of England (Lombardi 2010). The progress of reform of the IMS, including increased allocation and wider use of SDR as international reserve assets, could be facilitated when this kind of significant change in the IMF governance structure occurs.

On the second problem, that of appointments, the selection process for managing director should become more transparent and be open to qualified non-Europeans, including those from EMEs. Appointments to senior positions should be more merit-based, and better balanced between staff from advanced economies and EMEs.

Concluding Remarks

The “institutional mismatch” – the mismatch between the institutions and the market has been one of the fundamental causes for the instability of the global financial system. The development of institutions fell far behind that of financial markets over the last two or three decades. Integrated and tightly interconnected

1 Mervyn King, Speech at the University of Exeter, 19 January 2010.
financial markets and global economy now require new institutions including the IMS. However, the prospect on this goal is very dim. We can expect only an evolitional process toward this goal. It is also true that there is little that collective public policy decisions can do to promote that evolution.

History shows us that the world has suffered when incumbent powers fail to give rising powers their proper place. Inclusion of major EMEs, including China, Brazil, India, and others in the G20, has been the right move. Not only in the G20 but in the IMF, there has been a steady effort to shift voting power and representation (and therefore influence) away from the developed countries to the emerging and developing countries, thereby engendering a broader sense of ownership and trust in the IMF. The challenge now is how to make the G20 and the IMF more effective. Without institutional innovations within the G20, there is a high risk that its summits will follow the path of previous summit meetings, such as G7. Without substantial changes in governance structure and surveillance practices, there is risk that the IMF would continue to be marginalized in addressing global economic and financial issues.

The shape of the IMS in the 21st century will be significantly influenced by the views, interests, and requirements of the emerging powers. Asian countries so far have been passive followers of the international economic order, which was shaped by the West after World War II. They have grown fast in this global environment. Most Asian countries, so far, have been preoccupied with domestic growth and political stability issues, and lack the vision of how to shape the future global economic system.

Asia’s rising powers have now been given seats in the G20, a global economic governance forum since 2008. Yet they do not seem to be well prepared to provide new visions and leadership required to shape the future global economic system. Increased status and representation of Asian countries in the G20 give both privileges and responsibilities to Asians. To meet these responsibilities, Asians should put forth greater efforts to develop their intellectual leadership in global economic issues, including creating regional forums and upgrading the
role of think tanks.
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