International Economic Governance: Last Chance for the G20?

Summary

• The IMF and World Bank are still dominated by the United States, despite the growing importance of emerging markets such as China and India in the global economy.

• The more prominent role of the G20 since 2008 was intended to signal a shift in the balance of influence towards emerging markets, but the slow pace of reforms to the governance of international financial institutions has hindered this.

• The large emerging markets have responded by establishing new institutions, and China is promoting the use of the renminbi in a multi-currency international monetary system.

• The United States has opposed many of these initiatives, and remains unwilling to ratify governance reforms at the IMF. This stand-off risks fragmentation of the international system, and a shift away from multilateralism. In the process there is the risk that the G20, IMF and World Bank will become less effective, further hastening fragmentation.

• There is a role in the international economic system both for the G20 and the Bretton Woods institutions, and they are at their most effective when they work together. But the impasse over reforms, especially at the IMF, threatens to damage them.

• Individually and collectively, G20 members have a crucial role to play in modernizing international economic governance. Necessary steps include a change in the US position on IMF quotas, G7 support for emerging-market initiatives, engagement by BRICS countries in efforts to make the G20 more effective, and committed leadership from China during its G20 presidency in 2016.
Introduction

The world economy has changed fundamentally over the past 20 years. Following the Second World War, the United States emerged as the sole superpower in economic as well as security matters. But since the late 1990s there has been a transformation, with developing countries coming to occupy a pivotal space in trade and finance amid the rise of the ‘new powers’ such as China and India. The G20 was meant to epitomize this new order.

The shift from the postwar system dominated by the United States to a multipolar world of more dispersed economic power is evident, among other factors, in the change in the composition of global GDP. While the United States and other G7 economies accounted for 51.2 per cent of the world’s GDP in the early 1990s, their share has come down to 31.6 per cent in 2015. Over the same period, the combined share for China and India has risen from 7.7 to 24.3 per cent.

The key lesson from the 2008–09 global financial crisis is that the world economy is much more integrated than it was just a few decades ago. Finance, even more than trade, has been at the heart of this integration.

The need for international economic governance to adjust to the new realities was underlined by the financial crisis of 2008–09. Capital market turmoil and deep recession highlighted the full extent to which emerging markets have become more integrated into the world economy through trade, investment and finance. In particular, the crisis showed how financial shocks can now be transmitted rapidly across the international economy through interconnected banking systems and capital markets. China and other major emerging markets are rapidly becoming integral elements of the international financial system. As a result it is now clear that managing the world economy is no longer an exclusive matter for the advanced economies. Emerging markets and developing countries have to be part of the discussions and – importantly – the decision-making processes.

The G20 – an informal arrangement that since November 2008 has positioned itself as the ‘premier forum’ for international economic and financial matters – has been driving post-crisis efforts to recast the formal structure of economic governance. The rebirth of the G20 as a leader-level forum has been crucial in providing political impetus for international economic cooperation, and in engaging major emerging economies in international decision-making. Coordination has increased on a number of fronts, including financial regulation. Yet the international financial institutions (especially the IMF and World Bank) have been slow to react to demands for change, or to adapt to the rise of new economic players. In important respects, reform remains a work in progress, trailing behind the ongoing transformation of the global economy.

This paper looks at the development of the G20 since the global financial crisis and what has been achieved in the reform of international economic governance. It argues that the financial crisis triggered a sea-change in international policy cooperation but that further significant progress is needed.

The global financial crisis triggered some governance changes ...

The key lesson from the 2008–09 global financial crisis is that the world economy is much more integrated than it was just a few decades ago. Finance, even more than trade, has been at the heart of this integration. As a result, countries are more vulnerable to financial contagion, policy ‘spillovers’ and economic imbalances.

After the collapse of Lehman Brothers in September 2008, financial turmoil spread from the United States to banks in Europe and elsewhere. Wholesale markets froze, a credit crunch developed, trade finance dried up and global demand collapsed. The sharp fall in demand in developed economies started to hit growth in Asia and other regions.

The initial policy response by governments worldwide in the first year of the crisis was patchy and uncoordinated. Most G7 countries cut interest rates to almost zero, and followed this by introducing unconventional monetary policies – such as quantitative easing in the United States – to stimulate their economies. Big fiscal stimulus packages were put in place, particularly in America and China, boosting infrastructure spending.

But as the banking crisis spread, and as economies faltered, politicians turned to the G20. This brought together major advanced economies (including all of the G7 countries), some medium-sized advanced economies, and the largest emerging markets and developing countries, representing about 85 per cent of global GDP. The sheer scale of the crisis...
demanded a more comprehensive response than the G7’s limited scope could deliver. It also demanded recognition of the important role played by developing countries in the global economy. From 2008 onwards, the G20 was thus elevated from a forum of central bank governors and finance ministers to a summit of leaders.

The London summit in April 2009 marked the peak of G20 activism, bringing agreement on a series of measures to contain the crisis. Fiscal stimulus programmes – unprecedented in the scale of international coordination – and the provision of additional financial resources for the IMF and development banks helped to avoid a global depression and stabilise markets. A new body, the Financial Stability Board (FSB), was established to take forward regulatory reform of the financial sector (with a stronger remit and wider membership than its predecessor, the G7-derived Financial Stability Forum [FSF]). G20 members also committed to defending the system of open international trade against protectionism.

Some of these G20 initiatives have lasted beyond the early days of the crisis. In particular, the creation of the FSB cemented major reforms to the international framework for financial regulation. But some of the other early successes proved to be short-lived. Coordination of fiscal policies fell apart quickly. Central bank liquidity swap lines were allowed to lapse. Unconventional monetary policies, especially the US Federal Reserve’s quantitative easing, started to have a significant disruptive impact on G20 and non-G20 countries – as Brazil’s then finance minister, Guido Mantega, stressed a few days before the 2010 G20 summit in Seoul when he referred to the appreciation of emerging-market currencies on the back of a weak dollar as ‘currency wars’.

The 2009 London summit also marked an important step towards the reform of international economic governance and multilateral institutions. At the summit the G20 agreed to review the IMF’s quotas and voting rights to put in place a fair and effective balance between emerging markets, developing countries and advanced economies in exchange for an increase in the Fund’s resources.

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From the outset the emerging-market members of the G20 insisted that further reform of international governance should be an important part of the group’s agenda. Some progress has been made. The FSB – reconstituted from the former FSF – includes all members of the G20, despite initial push-back from the advanced economies. All emerging-market members of the G20 have at least two seats each on it, and Brazil, China and India have three (on a par with the G7 members).

Emerging markets have also secured progress on governance of the World Bank. A commitment to move towards equitable voting power, with an increase of at least 3 per cent of voting power for developing and transition countries, was made at the September 2009 Pittsburgh summit. The G20 put forward at its June 2010 summit in Toronto a detailed proposal that was subsequently agreed and adopted by all members of the World Bank. However, this commitment did not extend to the leadership of the World Bank, and in 2012 an American (albeit with dual US–South Korean citizenship) was once again appointed as the bank’s president.

... even at the IMF ...

However, the main emerging-market demand was still an increased say in the running of the IMF. Specific demands included an increase in the share of votes and seats on the Fund’s executive board; regular reviews of quotas (and the quota formula) to reflect future global economic changes; recruitment of more staff from emerging markets; and a more open selection process for the head of the IMF (as well as that of the World Bank). At successive G20 summits, emerging markets have become increasingly insistent on these points.

Relatively quick progress was made on reforms to the make-up of the IMF executive board, despite opposition from smaller European countries (which stood to lose most from these reforms). In practice the changes had a relatively minor effect, but they were significant in signalling a shift in the balance of representation away from the ‘old’ order dominated by advanced economies.

Quota reforms were also agreed rapidly – to then be approved by national parliaments. By the end of 2010 the IMF had formally adopted the G20’s proposals for quota reforms, which, once implemented, would have made China the third-biggest shareholder in the IMF, with Brazil, India and Russia also in the top 10. Hopes were thus high
that the IMF was on the way to becoming more globally representative in its structure, and to fulfilling the ambition set out for it in late 2008 when president Nicolas Sarkozy of France and British prime minister Gordon Brown called for a new international financial architecture – a ‘new Bretton Woods’. However, the reality has fallen well short of this lofty ideal. Implementation of IMF quota reform has been seriously delayed.

… but we are still waiting for a ‘Bretton Woods moment’

Unlike the 1944 Bretton Woods conference that led to the creation of the IMF and World Bank, the G20’s summits so far have not triggered a fundamental rethink of the global financial and monetary architecture and rules. Seven years after the 2008 crisis, the Bretton Woods framework remains largely intact despite deep changes in the world economy.

At the heart of the G20’s problems lies the fact that its members have radically different visions for its role – and for that of the international financial institutions – in managing the global economy.

The Bretton Woods institutions still reflect a US-dominated world economic order. The IMF and the World Bank continue to be headed by Western European and US nationals respectively. Both institutions also continue to be viewed in unfavourable terms as extensions of US economic and geopolitical influence. This is despite a softening of the so-called ‘Washington Consensus’, associated with the imposition of Anglo-Saxon liberal economic values on emerging markets, in the aftermath of the 1997 Asian financial crisis.

The voting structures of the international financial institutions have not kept pace with emerging markets’ growing importance in the global economy. The United States has over 16 per cent of the voting power in the IMF, giving it extensive influence in the organization and the ability to block important decisions. This remains the biggest obstacle to implementation of the quota reforms: they cannot come into effect until ratified by the US Congress, which remains firmly opposed to change.

At the Brisbane summit in 2014, G20 leaders (including US President Barack Obama) said in their communiqué that they were ‘deeply disappointed with the continued delay in progressing the IMF quota and governance reforms agreed in 2010 and the 15th General Review of Quotas, including a new quota formula’. They urged the United States to ratify the reforms and asked the IMF to ‘stand ready with options for next steps’.

The G20’s failure to deliver governance reforms

In part the lack of progress on reforms of the Bretton Woods institutions is due to the G20’s own ill-defined governance. By reinventing itself as a forum for heads of state from 2008 onwards, the G20 in effect positioned itself as a ready-made grouping for dealing with the financial crisis. But its structure suffers from design flaws: the need for consensus, the ‘rotating presidency’ format, and its members’ unwillingness to drop issues from its agenda. The G20 also has a mixed record of implementing leaders’ agreements.

Even though the G20 was leading the wider reform of global governance, UK Prime Minister David Cameron’s 2011 review of the G20’s structure and role did not propose significant internal governance reforms.

But at the heart of the G20’s problems lies the fact that its members have radically different visions for its role – and for that of the international financial institutions – in managing the global economy. The G7 countries considered the elevation of the G20 to leader-level body to be a short-term expedient to address the crisis. Their traditional view of crisis resolution was as a matter for countries (rather than for multilateral institutions) to manage through informal groupings of the like-minded. While the global nature of the 2008–09 crisis made it essential to involve emerging markets in an internationally coordinated response, the agendas of the Washington and London summits in 2008 and 2009 were still dominated by issues that lay firmly under national control: financial regulation, monetary and fiscal policies, central bank swap lines and IMF resources.

As a result the IMF and the World Bank were not ‘full members of the G20 club’, but were merely invited guests. The proposal in 2009 by the then IMF managing director, Dominique Strauss-Kahn, that the G20 and the International Monetary and Financial Committee (the governing body of the IMF) should be merged was rejected by the advanced economies. Instead the surveillance mechanism set up at the 2009 Pittsburgh summit – the Mutual Assessment Process – was managed by the G20 members themselves.

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By contrast, the non-G7 members of the G20 generally saw the international organizations as the proper institutions to deal with the issues that the crisis had thrown up. These countries favoured the formal, universal, treaty-based international institutions as the most legitimate decision-making bodies, and viewed the G20 as a stepping stone to reform giving emerging markets an influence within them that matched their growing importance in the global economy.

This difference in view has made it more difficult for the G20 to deliver on its promises. As a result, disenchantment with the group has started to set in. Now that the global crisis has abated, the overriding sense of urgency has dwindled, as has countries' willingness to take into account the concerns of others in their national policies. The G20's failure to follow through on commitments to reform the international system has led some countries to take matters into their own hands.

**Emerging markets demand further governance reforms**

In line with their increasing role in the global economy, the biggest emerging markets (China in particular) have set out to establish a new world economic order that no longer allows US domination of the Bretton Woods institutions. Their ambitions include the development of an international financial system that does not revolve around the US dollar. Zhou Xiaochuan, the governor of the People’s Bank of China, has argued for a multi-currency international monetary system, warning against basing the system on one dominant national currency, and challenging the ‘exorbitant influence’ and ‘exorbitant privilege’ of the United States in international economic governance.6

One response by the emerging markets to the failure to secure IMF governance reforms has been to establish new regional and global banks. The BRICS countries (Brazil, Russia, India, China, South Africa) have announced the establishment of the New Development Bank (the ‘BRICS bank’), which will eventually have a capital base of $100 billion. China has also partnered with other Asian countries (and some advanced countries such as the United Kingdom, France, Germany, Italy and Australia) in setting up the Asian Infrastructure Investment Bank (AIIB). Although there is a genuine need to fill the large infrastructure financing gap in the developing world, setting up these new banks is also intended to boost the influence of emerging countries in global economic affairs, and China’s influence in Asia.

As well as new banks, institutions have been established or expanded that overlap with the IMF. In the wake of the Asian financial crisis, the Chiang Mai Initiative was launched in 2000 to provide mutual support among Asian countries. The scheme’s funding was expanded in 2012 when the initiative was ‘multilateralized’: extra financial resources were pledged for countries facing balance-of-payments crises, and the ASEAN+3 Macroeconomic Research Office was set up to carry out macroeconomic surveillance in the region – functions that had previously been the sole preserve of the IMF. The BRICS have also signed a treaty to establish a Contingent Reserve Arrangement with a capital base of $100 billion to provide mutual support in the event of balance-of-payments problems.

These emerging-market-led institutions present an implicit threat to existing international institutions, and are designed to increase the pressure for further governance reforms. The creation of an international reserve currency that could complement the US dollar and become a significant element of a multi-currency international monetary system is the other significant building block in emerging markets’ bid to remake international economic governance. China’s pursuit of a multi-currency system began in 2009 with the so-called ‘renminbi strategy’ to promote the use of its currency in regional trade. The strategy also sought to promote the renminbi more generally to reflect China’s role as an engine of global economic growth.

The United States is clearly uncomfortable with the attempts by emerging markets to carve out a more significant role in international economic and monetary affairs. It is especially concerned about China’s moves, which carry geostrategic implications for Asia and beyond. These concerns became clear in 2015 when the Obama administration could not hide its unease and publicly rebuked the United Kingdom for its participation in the AIIB and accused it of ‘constant accommodation’ of China.7

The United States has a point. There are legitimate concerns about the governance of the AIIB; for example, given China’s record of lending to developing countries with poor governance themselves. But in opposing these initiatives, the United States risks losing the contest to determine the nature and effectiveness of international organizations, systems and rules. The world economy is no longer that of the Bretton Woods era. While the United States may be able to delay some developments, in doing so it risks damaging the very system over which it seeks control. The country needs to decide whether a US-dominated but weakened and ineffective IMF that is incapable of dealing with global economic crises makes

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for a healthier US economy, or whether a stronger Fund that takes into greater account the interests of the rest of the world would be more effective. Rather than opposing the inevitable transformation of the economic order, the United States should ensure that an increasingly multipolar system does not lead to a world of separate and disconnected blocs.

A more fragmented approach to governance ahead?

The danger is that the new economic powers will continue to create their own institutions and their own frameworks of governance, aligned with their own interests, which could lead to a fragmented international system. For example, the establishment of the AIIB might result in two blocs of economic influence in Asia – one led by China and the other by the United States and Japan (which dominate the existing Asian Development Bank).

There is also a risk of fragmented standards. Diverging trade standards are already a significant threat, as China has reacted to its exclusion from the Trans-Pacific Partnership (TPP) by accelerating its own trade arrangements in the region. The recently launched ‘One Belt, One Road’ initiative to develop trade routes with Central Asia and Europe remains, for now, an expression of policy direction for China’s leadership rather than an actionable plan. However, it has the potential to create a more formal framework within which new institutions such as the AIIB could take the lead in infrastructure investment, development, economic surveillance and financial support for countries in crisis.

Given its membership, role and political leadership, the G20 is uniquely placed to try and reconcile differences and prevent fragmentation of the international economic system.

Maintaining a harmonized, consistent and multilateral framework of rules and standards is a global public good. Given its membership, role and political leadership, the G20 is uniquely placed to try and reconcile differences and prevent fragmentation of the international economic system. Over the years it has been able to strike a balance between the interests of the developed and developing worlds. But to continue succeeding in this it will need to ensure that the international architecture of governance reflects the evolving roles of emerging markets.

The 2014 Brisbane summit called for ‘options for next steps’ to be developed in order to move the governance agenda forward. What might those next steps be?

‘Options for next steps’

The governance of international institutions is at a crossroads, and the G20 needs to act. One possible outcome is a continuing stand-off between the demands from emerging markets for a greater say in the running of the existing institutions and the insistence by advanced economies (especially the United States) on maintaining their dominant position. In that case, the emerging markets could increasingly withdraw their support for joint international actions within the G20, and continue to build parallel institutions to rival the IMF and World Bank.

A fracturing of the G20 into different camps is already happening to some degree, as seen in the strengthening of the BRICS grouping and the renaissance of the G7. On trade issues, the negotiation of ‘mega’ free-trade agreements (including the TPP, the Transatlantic Trade and Investment Partnership and an EU–Japan agreement) has begun to marginalize the World Trade Organization. As a result, different ‘rules of the game’ and standards are starting to emerge.

But this fracturing is not inevitable. If the G20 can regain its cooperative spirit, it could help mend the cracks that are starting to emerge. As an international body it has two comparative advantages. First, because it is a country-based forum, its members have ‘ownership’ of the G20’s decisions – which carry greater weight as a result. The G20 can be more effective when national governments are required to implement its decisions (such as the supply-side actions identified in the Brisbane Action Plan for growth) or where national financing is needed (whereas the IMF and World Bank have universal membership). Second, the G20 demonstrated during the financial crisis that it can achieve consensus among its members faster than is possible within the leading international organizations.

The drawbacks of the G20 are that it excludes many countries, does not have the legitimacy that comes from a broad and inclusive structure (at least, relative to the membership of the IMF and World Bank), and does not have treaty-based powers to ensure that its agreements are implemented. Ultimately, its credibility depends on whether agreements reached at leaders’ summits are implemented.

There is room in the international economic governance architecture for the G20 as well as the international organizations, and they are at their most effective when they work together. But the current impasse over governance reforms, especially at the IMF, threatens to undermine the international organizations and reduce the G20’s relevance as a body. G20 members can remedy this, but they will need to use the political clout of their leaders’ involvement to protect and enhance the multilateral institutions as well as the G20 itself.
A strategy to modernize international economic governance

Several actions need to be taken at all levels – by individual countries, by groups of G20 members and by the G20 collectively – in order to modernize international economic governance.

- **The United States has to show true leadership.**
  If Congress continues to put narrow and short-term interests first, and refuses to ratify the internationally agreed quota reforms for the IMF, the Obama administration will have to act.
  - First, it should continue to express vocal and public support for IMF quota reforms.
  - Second, it should back governance reforms that do not require congressional approval – such as ending the convention by which the IMF managing director is always a European and the World Bank president an American, and championing greater diversity in staff recruitment in the international organizations.
  - Third, it should show support for the AIIB and other emerging-market initiatives to build new institutions. This would signal that the United States does not see them as an alternative and a threat to the existing international organizations.

- **Other G7 countries must be prepared to address the concerns and support the initiatives of emerging markets.**
  - First, those that have not already done so (for example, Japan) should become members of the AIIB (despite US opposition). This would reemphasize how isolated the United States is on this issue.
  - Second, they should support the US administration in lobbying Congress to ratify the governance reforms.

- **The BRICS should recognize the G20 as an important part of the international system.**
  - First, they should work to make the G20 more effective, and not hold it hostage to the approval of reforms at the IMF and World Bank.
  - Second, they should make clear that the United States (and other advanced economies) would be welcomed as members of the AIIB and other BRICS-led institutions.

- **China has a particular responsibility to make the G20 work,** especially if the coming summit in Antalya, Turkey fails to make significant progress on governance reform. In 2016 China will take on the presidency of the leaders-level G20. Through a positive and focused agenda for the G20 next year, it can not only demonstrate its commitment to the G20 as a forum, but also show the potential of the G20 to make progress on difficult international economic issues.

- **Finally, the MIKTA countries need to help broker a ‘Plan B’ for governance reform.** These countries have most to lose from a dysfunctional international system because they are not part of a powerful grouping (the G7 or the BRICS). This ‘Plan B’ should involve a root-and-branch reform plan for voting structures within the IMF to modernize its governance further. But this plan would have to be credible in order to increase the pressure on the US Congress to ratify the agreed quota reforms.

All elements of this strategy are necessary to make it work. The challenge is for international economic governance to move in sync with the changes continuing to take place in the global economy, and to avoid the fragmentation of institutions and standards.

All countries and groupings within the G20 have an important role to play. The United States’ initial response to China setting up the AIIB suggests that it is still in defensive mode. But it faces a critical test. If it is willing to consider reforms that dilute its control over decision-making in the IMF and other international organizations, it will help deliver an international framework of institutions that is more effective and better for the health of the global economy. If it does not, it could seriously undermine the G20 and the international organizations as effective institutions for international economic cooperation. As for China, it has a crucial role to play. Its presidency of the G20 in 2016 provides a big opportunity to move in the right direction.

* Mexico, Indonesia, South Korea, Turkey and Australia.
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Questionnaire by the Observer Research Foundation (ORF) about expectations from the G20 and Global Economic Governance. 

Please take 10 minutes and complete the survey below in four easy steps and let us know what you think about the G20! Take our 10 minute survey on the G20 below!

1. Have the institutions of global economic governance (e.g. IMF, FSB, WHO, FATF) failed us? Yes, the institutions can neither foresee nor address global issues effectively. No, without their experience and expertise world would have been in a deeper crisis.

2. Which approach to global economic governance is most effective? The G20 (or Group of Twenty) is an international forum for the governments and central bank governors from 19 countries and the European Union (EU). Founded in 1999 with the aim to discuss policy pertaining to the promotion of international financial stability, the G20 has expanded its agenda since 2008 and heads of government or heads of state, as well as finance ministers, foreign ministers and think tanks, have periodically conferred at summits ever since. It seeks to address issues that go beyond The G20 has become the preeminent forum for international economic coordination. Twenty years after its creation, the paper reviews its performance with respect to the coordination of macroeconomic policies. Russian Journal of Economics 5 (2019) 412-440 the last 20 years.

In particular, we are interested in two main questions: (i) have the G20 summits succeeded in promoting macroeconomic policies with positive cross-border consequences, while preventing the opposite? (ii) to what extent has expanding the G7 to include a more diverse group of countries significantly changed the discourse and affected substantive outcomes? The G20 was created to make economic global governance more democratic and effective. Major states should now assume more responsibility in making the world safer, as well as more economically inclusive and politically harmonious. The G20 summit is of particular importance to German Chancellor Angela Merkel, who, as chair, will get a last chance to shine on the international stage ahead of the German federal elections in September. But a success is not guaranteed, especially for the second basket, given President Donald J. Trump’s withdrawal of the United States from the historic Paris Agreement on climate change. The G20 so far has made important progress in reshaping the governance of global finance by implementing macro-prudential policies, developing strict rules on the "too big to fail" problem, increasing the lending capacity of the International Monetary Fund (IMF) and collecting richer information on the shadow banking system. The G-20 has also played a crucial role in strengthening the international financial regulatory system, including better coordination across countries. A forum for international economic cooperation, agreed to act together to support the global recovery through a Framework for Strong, Sustainable and Balanced Growth with a Mutual Assessment Process, and to reform global financial institutions, such as the International Monetary Fund and the World Bank.