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**Remarks**

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## **Emerging Powers and Global Governance:**

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### **The Changing Needs for Global Liquidity: The Role of Cross Border Capital Flows**

When the IMF was founded, international financial flows were mainly related to trade financing: private sector financial flows were of limited scope and importance. Indeed, the Bretton Woods system did not envisage free capital flows and Article VI of the IMF Articles of Agreement empowered the IMF to prohibit capital outflows from countries when necessary. Balance of payments problems were to be solved by orderly exchange rate adjustments governed by the IMF. Thus, until the 1970s, the number of financial, banking and debt crises was few: in fact, the drawal of IMF resources by member countries was limited to 100 per cent of their respective quotas, and only 25 per cent in one year.

With the breakdown of the Bretton Woods System in 1973, and the advent of floating exchange rates and free private capital flows, and the oil price rises of 1973 and 1979, the frequency and seriousness of financial crises also increased. As Boorman has documented in the background paper for this session, between 1970 and 2011, there were 147 systemic banking crises, 218 currency crises, and 66 sovereign debt crises. Until 2007, the vast majority of these crises occurred in the EDEs. There have been more than 20 systemic banking crises since 2008, the majority of them being in AEs. Consequently, many EDEs are now counted among the group of creditor countries, and AEs among the debtor countries group. The greater frequency of crises in the post-Bretton Woods period has brought to the center stage the increasing role of the IMF as a lender of last resort and consequent arbiter of economic policies, and hence a lead role in the framework of global economic governance.

All the background papers note the role of increasing and volatile cross border capital flows in the increasing incidence of banking, financial, exchange rate and sovereign debt crises. Yet, they still argue for greater liberalization of capital accounts, and flexibility of exchange rates. Recent and ongoing research is now giving greater consideration to the issue of capital account management, and on greater monitoring of capital flows. Questions are also arising on the role of unconventional and excessively accommodative monetary policy in giving rise to increasing and volatile capital flows. So the new financial architecture also needs to give consideration to discussion of these issues in an organised manner in order to arrive at some consensus on how this issue is to be managed in the future. Can the IMF be given a role in overseeing capital flows?

## Changing Role of the IMF

The functions of the IMF have been changing along with changes in global trends in economic orthodoxy and policies, and with the increasing frequency of crises. After the breakdown of the Bretton Woods arrangements in 1973, as economic orthodoxy moved to floating exchange rates and freer capital flows, global monetary policy lost its previous anchors and countries could pursue independent monetary policies. But with the consistent expansion of trade with the graded success of GATT and WTO over the years, along with increasing cross border private capital flows often financing the sovereign debt needed for expansionary fiscal policy in many countries as also the continued liberalization of policies to attract private capital flows, the frequency of banking, exchange rate and sovereign debt crises rose. The need for IMF assistance increased correspondingly. Exceptional access was invoked 11 times in the 1990s, with the Korean program of 1998 going up to 2000 per cent of the country's quota. In the NAFC, the utilization of access limits greater than 1000 per cent has been routine for a number of European economies, both those in transition, like Hungary, Latvia, Ukraine, Romania and AEs like Iceland, Greece, Portugal and Ireland.

Thus, as the global economic, monetary and financial systems have evolved over the IMF's history of 70 years and as dominant western economic policy orthodoxy has changed, so has the role of the IMF. With the ongoing changes in technology in the 1990s and beyond, and much freer capital flows, opening of capital accounts and overall financial liberalization in AEs and EDEs alike, financial interconnectedness has meant ever larger sizes of rescue programs. Whereas, in 1981, India needed a program of less than US\$ 5 billion to solve its balance of payments crisis at that time, the recent IMF programs for small countries like Portugal, Ireland and Greece have each exceeded US\$ 25 billion. In fact, the need of these countries has been so large that IMF resources have had to be supplemented by European institutions: so much so that the IMF has been much the junior partner in these programs in terms of resources, and possibly in program design. The recent and ongoing developments in Greece have brought in focus some of these issues.

Global economic governance and the IMF are today at a crossroad. The global economy has now become much more complex and inter connected with the expansion of global GDP and other developments that have taken place over the last two or three decades. As international trade has become virtually free across the board as a consequence of the successive rounds under GATT and WTO, and as capital accounts have also become more and more open across the world, there is now much greater financial interconnectedness across borders of countries. Hence, a sneeze in one systemic country can lead to pervasive flu across the globe. A financial crisis in even a non-systemic country could lead to contagion across its region. The large Greece bail-

outs in 2010 and 2012 were justified on the basis of a fear of contagion across the Euro zone. Thus, it is clear that in the years and decades to come, the maintenance of financial stability across the world will become more and more difficult and challenging. Attention needs to be given now to the global financial institutional architecture that should be in place to help the world manage better and more effectively the fallouts from financial crisis that might occur in the coming decades, despite far reaching ongoing efforts to strengthen financial sector regulation and supervision.

There are two aspects related to IMF reforms: first, an increase in the size of its quota resources that is commensurate with its role in the global economy for ensuring financial stability and as a lender of last resort, and second, reform in its governance through equitable distribution of voice and vote. Both these reforms are equally important and interconnected. The size of its quota resources should have some relationship to the magnitudes of global GDP, global trade and global financial transactions and the size should be such as to provide credibility in markets in terms of its effectiveness in dealing with potential crises.

As the background papers for this session have noted, the international monetary framework that was set up after World War II has not changed much despite the significant transformations taking place in the global economy. The international financial organisations remain dominated by the advanced economies.

Prospective changes in quotas and voting shares would lead to reduction in the shares of the European countries, which retain disproportionate weights in the IMF despite their shrinking share of the world economy. US leadership of the international institutions remains of great value, and it is important that, among the advanced economies, the US retains its dominant position. The Bretton Woods institutions owe their founding to US vision after the Second World War. US financial markets continue to be the most dominant in depth and efficiency – and the dollar is still the world’s dominant reserve currency and will remain so for the foreseeable future. Although the role of the emerging economic powers is increasing, their soft power is not rising at the same pace, underlining the importance of maintaining US leadership.

### **Economic Weight Shifts**

The world is on the cusp of an epochal change in global economic power, not seen during the past 200–250 years since the start of the industrial revolution.

After more than 200 years the centre of gravity of the global economy is shifting back towards Asia from the North Atlantic. Yet there is little evidence of this change being reflected in the framework of global economic governance, where we see little

substantive change in the governance of the international financial institutions, like the International Monetary Fund and the World Bank.

The global economic structure was broadly stable from 1945 until the turn of the millennium. The advanced economies' share in global GDP was around 60 percent through that period though there were changes in relative weights among the advanced economies themselves, particularly related to the postwar rise of Germany and Japan.

Change has gathered pace since 2000, with economic weight shifting from the North Atlantic to Asia. This is expected to accelerate further over the next couple of decades. So, changes in global economic governance will have to be more substantive than the current incremental change envisaged.

The share of emerging and developing economies in global GDP is expected to increase from 40 percent in 2000 to over 60 percent by 2020 in purchasing power parity terms and from 20 to 40 percent in market exchange rate terms. The share of G7 countries in global GDP (PPP) is expected to fall from about 44 percent in 2000 to about 30 percent by 2020, with a corresponding increase in the share of Brics from 19 percent in 2000 to 33 percent in 2020 – part of much bigger changes expected up to 2050.

The Brics countries, particularly China and India, are acquiring large economic weight because of their population size, despite relatively low per capita incomes. Greater participation in global economic governance will require greater assumption of responsibility. The transfer of governance roles needs to be tempered by the relative lack of sophistication and size of economic institutions in these aspiring countries. But we can expect that this gap will be bridged before too long.

As a response to the 2008-09 financial crisis almost all advanced economies, the United States, the U.K., the Eurozone and Japan, have practiced unconventional excessively accommodative policies for an extended period. Interest rates have been near zero in all these jurisdictions for more than 5 years. Although these policies did succeed in staving off a depression, economic recovery has been slow, and is still uncertain. Will the road to recovery be smooth or will we see the emergence of potholes and speed breakers on the way? We have already observed very significant capital outflows taking place from China over the past year; and collapse of the oil and commodity prices could also generate significant capital outflows from exporters of these commodities. Furthermore the excessively accommodative monetary policies have also led to the existence of large debt overhangs in advanced and emerging markets alike. Hence, the eruption of financial instability in some parts of the world would not be surprising in the near and medium term. Consequently, at the current juncture there is a continuing need for the International Monetary Fund to exist and to be seen to be effective and credible: thus it needs to be adequately resourced.

As the emerging economies have grown individually and collectively, and as international financial markets have become more interconnected, resolution of financial and balance of payment crises now need large international resources: witness the size of bailouts that had to be organized for relatively small European countries such as Ireland, Portugal, Cyprus and Greece. The resources available with the IMF had to be supplemented by European resources: in fact, the IMF was the junior partner in these programmes in terms of resources. A well resourced European Stability Mechanism (ESM) has emerged to take care of such problems that may emerge in the future in Europe. Similarly, the Chiang Mai Initiative (CMI) also has substantive potential resources for addressing crises in Asia. But, as of now, these institutions expect to rely on the IMF's staff for designing programmes, and also need supplemental IMF resources as necessary. If crises break out in other parts of the world, there will be even greater need for the IMF to function effectively in its role in preserving financial stability and as a lender of last resort. To perform effectively, the Fund must have adequate permanent quota resources to retain and enhance its credibility and legitimacy.

So it is essential that its quota resources are increased regularly, commensurate with the expanding size of the global economy and financial markets. Moreover, such regular quota reviews would also ensure that the emerging powers get their rightful share in the IMF's governance, extending the evolution since 1950. In order to avoid the delay experienced in ratification of the 14th Review consideration needs to be given to injecting some automaticity in the mandated five yearly quota reviews.

Decisions on IMF governance and the use of IMF resources can no longer be made in the cosy clubs of the G7 and G10: some of the action has already shifted to the G20.

European countries remain overweight, with the 'advanced Europe' group (European Union, Norway and Switzerland) taking a third of board seats, and more than a third of board voting power: the relative constancy of their quota shares is striking, since their share in GDP is falling consistently.

### **US Needs to Retake Leadership**

Whereas there needs to be an overhaul of global economic governance, giving a greater role to emerging economic powers, it is still necessary for the US to retake leadership in the IMF and in global economic governance.

What is remarkable is that, in addition to the under-representation of the Brics, the country that is most underrepresented in the IMF, in relation to its share in global GDP, is the US. Whereas the GDP shares of the US and EU are broadly comparable (16.7 and 17.9 percent in PPP terms, respectively), in a new quota review the calculated quota share of the US, based on the latest 2013 data, would be 14.5 percent, compared with 27.6 percent for the EU (based on the current quota formula).

Correction of this striking imbalance in favour of the US is important to preserve US leadership in the IMF and overall in global economic governance. The chances of obtaining congressional approval for future quota reviews would also be enhanced if such a correction is done. The existing quota formula will need revision to accomplish this: essentially the role of GDP would need to be increased. If an appropriate correction is carried out in this manner, it would postpone by some years the prospect of the US quota share dropping below the important 15 percent threshold. It would also better reflect the changing composition of the global economy on a dynamic basis, with the emerging economic powers getting better representation along with the United States. On this matter there is a confluence of interest between the emerging economic powers and the United States.

Further ahead, reviews of IMF quotas and governance need to be more radical – with significant implications for overall quota and voting shares.

In order to reduce the very divisive discussion that takes place in every quota review consideration should be given to injecting greater automaticity in the size of quota resources that the IMF should have in each review. Consideration could be given to arriving at a formula for deciding on total IMF quota resources on the basis of some desirable proportions of global GDP, total trade merchandise and services and total financial transactions in the global economy<sup>1</sup>. The membership could, for example, agree to maintain some stability in the ratio of overall quotas to world GDP, trade and financial flows so as to avoid the declining trend visible since the 1990s. If such a formula can be arrived at, it would provide great stability to the size of resources, relative to the needs of the global economy, available to the IMF. Such an agreement on the broad principles can helpfully reduce the time spent in the Board's deliberations.

### **Emergence of a Multipolar World: Increasing Role of Regional Financial Arrangements**

We also need to note the emergence of the various regional financial arrangements (RFAs), essentially over the past decade and during the period when IMF quota resources have not significantly increased. The Chiang Mai initiative involving a mutual multilateral swap amongst the ASEAN plus three countries evolved as a consequence of the Asian financial crisis of 1997. This multi currency swap now amounts to a potential total of resources amounting to US\$ 240 billion. The European Stability

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<sup>1</sup> Global output, trade and gross financial flows can be expected to continue with their upward trend and hence the IMF's quota resources need to increase commensurately. Although growth in both AEs and EMDEs has slowed down since the NAFC, it remains substantially positive, with growth in EMDEs still outpacing that in the AEs. Therefore, the view that the level of global output might not increase in the coming decades (there might only be a shift of global output in favour of the EMDEs) and hence there may not be case for an increase in the level of IMF quota resources does not appear to be realistic.

Mechanism (ESM) has similarly arisen from the European sovereign debt crisis and covers all the Euro zone countries. Its subscribed capital amounts to Euro 700 billion, with paid in capital of Euro 80 billion. The latest entrant to the RFAs is the BRICS currency reserve arrangement (CRA) which is also structured in the nature of a multi currency swap. The potential resources available with the CRA amount to US\$ 100 billion. In addition, there is also a plethora of other bilateral, and some multilateral swap arrangements, that have grown in a manner similar to the increasing number of preferential trade arrangements arising from the failure of the WTO Doha round. Consequently, the total volume of resources available among RFAs and other swap arrangements is in fact greater than the total resources available to the IMF, including its quota and borrowed resources.

Thus, the international financial architecture to deal with global financial stability and resolution of crises is much more dispersed beyond the IMF than was the case until the turn of the century. An ideal solution to avoid an emergence of a plethora of RFAs would be to have IMF's governance structure more attuned to shifting global economic realities. If progress on this front is glacial, as has been the case since the late 1980s, then clearer new arrangements need to be designed on the respective roles of the IMF and these RFAs. In one view, the existing arrangements between the IMF and the RFAs are appropriate and there is no evidence of any coordination failure and hence no need to review the existing architecture. The developments relating to the Greece program involving the troika – the Fund, the European Commission (EC) and the European Central Bank (ECB) – do clearly point towards the need for an improvement in the institutional architecture.

The global economy is thus clearly in the cusp of an epochal change and if we have to ensure stability in the global economy and the global financial system, significant changes have to take place so that global economic governance arrangements are seen to be equitable, fair and effective from the point of view of different stakeholders. The era of North American and European dominance is now waning and other economic powers are emerging. This must be recognized and responded to adequately.