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# The G20 and global financial governance

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>> After the 1997 Asian financial crisis and its contagion through the developing world, a major discussion on reforms of the global financial architecture took place, with rather limited success. When the global financial crisis hit, first through the eruption of the subprime crisis in August 2007 and, in particular, the global financial meltdown of mid-September 2008, the world had a strong sensation of déjà vu, not only in terms of financial crises and their contagion, but also of the inadequacy of international institutions to deal with them.

## THE GLOBAL FINANCIAL CRISIS

The global financial crisis has led to a series of reforms. To evaluate them it is useful to define five basic objectives that such architecture should meet. Those objectives are: (i) to regulate the financial and capital markets in all countries, as well as cross-border transactions, in order to avoid the excessive accumulation of risk; (ii) to offer emergency financing during crises, especially to ensure liquidity, complementing the functions of the central banks, which act as lenders of last resort at a national level; (iii) to provide adequate mechanisms at an international level to manage problems of over-indebtedness; (iv) to guarantee the consistency of national economic policies with the stability of the world economy, and to avoid national macroeconomic policies that have adverse effects on other countries; and (v) to guarantee an international monetary system which contributes to the stability of the international economy and is perceived as fair by all parties. The first three of these mechanisms may be seen as related to global financial regulation, the last two to global macroeconomic policy.

**FKI** THE FEDERATION OF KOREAN INDUSTRIES

**G | M | F** The German Marshall Fund  
of the United States

**FRIEDRICH  
EBERT  
STIFTUNG**

 Presidential Council on Nation Branding

 Korea  
Foundation  
한국국제교류재단

**KIEP**

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»»»»» Seen in this light, the most important advances have been made regarding the first two objectives, with some progress in relation to the fourth one. In contrast, debt workouts have not been placed on the agenda and although global monetary reform has been proposed by the central government of China and the 2009 Commission of Experts convened by the President of the UN General Assembly on Reforms of the International Monetary and Financial System, it has also been absent from the G20 agenda. The Republic of Korea's emphasis on a global financial safety net represents a further advance in the second area, and France has already placed the fifth issue on the agenda for the 2011 Summit.

One of the most important breakthroughs in the international debate of the last two years has been the recognition that the international financial crisis was clearly associated with inadequate supervision of financial activities. This is precisely the sphere in which the G20 has played a very important role, especially in reaching agreement on certain principles, the implementation of which, nonetheless, remains the subject of debate. The United States has already approved an important financial reform (the Dodd-Frank Bill), which is still subject to debate in Europe. The Basle Committee on Banking Supervision should approve by November 2010 an important set of reforms, including increases in capital requirements, a stricter definition of capital, a mechanism of countercyclical capital or provisions, strengthened liquidity requirements, and a new maximum leverage limit to restrict banks' total assets as a proportion of Tier 1 capital. Both the scale of the measures and the speed at which they will be implemented are still unclear.

The most important gap in the debate on regulation is the absence of cross-border capital flows from the agenda, particularly of the destabilising effect that procyclical capital flows can have on global financial stability, including carry trade in recent years. Developing countries have been severely hit by procyclical capital flows in the past, and some European countries have been equally affected by this factor during the current crisis.

This means that capital account regulations can have an important role for financial stability, as much as prudential regulations, and that the latter should take into account some aspects that are related to cross-border flows, such as currency mismatches in portfolios. The IMF has played a positive role in this regard, by launching a still incipient discussion on the role of prudential capital account regulations. This issue should be at the core of the discussion of the development dimensions of the global financial safety net that the Republic of Korea has placed on the agenda for the next G20 summit.

The history of all crises indicates that the international system demands a dynamic response from the IMF, awarding emergency financing subject to low (or at least appropriate) levels of conditionality. Improvements in this area can be seen as a second important area of recent progress. In March 2009, the IMF created a preventative facility, the Flexible Credit Line (FCL), for countries with solid fundamentals but a risk of facing problems in their capital account. Other credit lines were doubled and a broader use of the ordinary Fund facilities (the stand-by agreements) for preventative purposes (the so-called 'high-access precautionary arrangements') was authorised. In turn, in December 2009, the IMF reformed its concessional loan lines to a menu of options according to different situations facing low-income countries in relation to their debt vulnerability and their macroeconomic and public finance management capacity. Advances in conditionality have been somewhat frustrating, however. Although the relationship between loan disbursements and structural conditionality was eliminated in March 2009, conditionality seems to have gone back to old, highly controversial practices in recent European programmes.

The capitalisation of the world and all regional development banks can be seen as an additional area to increase the availability of countercyclical official funds to counteract the procyclical patterns of private financing. Indeed, the recognition that multilateral development banks have a countercyclical role should be seen as an advance in itself,

as it had not been clearly recognised before the crisis. However, capitalisation as well as disbursements came with a lag, in such a way that multilateral banks played a somewhat passive role during the peak phase of the crisis, although responding dynamically later on. Automatic rules must therefore be introduced to speed up the capitalisation of banks and to speed up disbursements.

Macroeconomic policy coordination has also seen some progress, although unfortunately it has continued to operate outside the IMF, the international organisation that should be in charge of this process. The initial countercyclical response of the G20 countries should be seen as an asset,

and it was crucial in avoiding the recurrence of a great depression. The controversies that erupted on the speed of fiscal consolidation at the most recent G20 meeting in Toronto may be seen, however, as a step backwards in this process, as is the growing reluctance

of several European countries to place priority on the countercyclical role of macroeconomic policy under the current circumstances. Much more limited advances have been made on global imbalances and exchange rate management. Global imbalances fell as a result of the crisis, but the risk of their reappearance is evident. China announced the reintroduction of some exchange rate flexibility before the Toronto G20 summit, but the broader issue of exchange rate volatility has not been on the agenda.

One central problem of the current international financial architecture is the absence of an effective mechanism to handle debt crises, similar to the bankruptcy procedures that exist in all national legislation. The current structure is fragmented (Paris and London clubs, and collective action clauses), and most negotiations tend

to take place through ad hoc initiatives, including those for low-income countries (the Heavily Indebted Poor Countries Initiative and the subsequent Multilateral Debt Relief Initiative). This mix of fragmented and ad hoc arrangements has proven to be suboptimal, in terms of guaranteeing both a timely response to crises and horizontal equity in the treatment of different debtors and well as creditors. So, the design of an explicit international debt resolution mechanism should be placed on the agenda, and indeed may be needed this time to manage the problems faced by some European countries, particularly Greece.

Finally, the global monetary system has shown three basic deficiencies in its functioning that have been emphasised over the years: (i) its bias against countries running deficits, which generate global recessionary effects during crises; (ii) the particular instabilities and dependence on US macroeconomic policies created by the use of a national currency (the US dollar) as the major world currency; and (iii) the inequities associated with the transfer of resources from developing to major industrial countries generated by the growing demand for reserves by the former to manage global financial instability.

Most of the alternative proposals on the table involved fulfilling the expectations created when the IMF Special Drawing Rights (SDRs) were launched in the late 1960s, of transforming these into the major global reserve asset. An important step during this crisis was, therefore, the London G20 decision to revive this dormant mechanism of international cooperation, by issuing the equivalent of \$250 billion, together with the decision by the US to complete the Congress approval process for the smaller 1997 allocation. The IMF decision of July 2009 to allow the issuing of securities denominated in SDR to draw in resources from some emerging economies (Brazil, China and Russia) can also be considered a step in the direction of creating a 'substitution account' to manage the varying demands for reserve currencies. However, these areas only constitute the

## The design of an explicit international debt resolution mechanism should be placed on the agenda



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»»»»» beginning of a debate of reforming the global monetary system that, hopefully, will be taken forward by the G20 in France.

**THE GOVERNANCE OF GLOBAL  
MACROECONOMIC AND FINANCIAL  
COOPERATION**

Three interesting – although incomplete – steps in the direction of improving global financial governance have been the decision to extend the membership of global financial regulatory institutions; the still highly insufficient steps to improve the voice and representation of developing countries in the Bretton Woods institutions (BWIs) as mandated by the Monterrey Consensus; and the decision in Pittsburgh in 2009 to designate the G20 as ‘the premier forum for our international economic cooperation’.

Undoubtedly, one of the most important G20 decisions was to give all its members access to regulatory organisations on financial matters, especially to the Financial Stability Board (previously Forum), FSB, which has now been assigned the duty of coordinating the tasks of world financial reform. However, this positive decision faces several drawbacks. The first is the very uneven number of representatives from different countries, which means that, with the exception of the BRICs, emerging economies represented in the FSB have one or two representatives while each of the G8 countries has three. The second problem has to do with the fact that the heads of both the plenary and the four committees that make up the FSB are headed by developed countries – in open contrast, it must be said, with the four working groups set up by the G20 between November 2008 and April 2009, each of which was headed by one developed and one developing country.

The more fundamental problems are, however, the total lack of representation of small and medium-sized countries; the ad hoc nature of the arrangement and the lack of a formal secretariat (that could be provided by the Bank for

International Settlements); and the absence of accountability to a representative political body. For these reasons, a desirable transition would be to formally create or adapt one of the existing international organisations to play the role that the FSB plays today. The most appropriate one would be the Bank for International Settlements (BIS), but a prerequisite for this institution becoming the world financial authority would be a considerable enlargement of its membership to transform it into a truly global institution.

It must be added that in March 2009, the Basle Committee also included for the first time various developing countries (Brazil, China, the Republic of Korea, India and Mexico), as well as Australia and Russia. In July 2009, it widened its membership still further, to G20 countries which were not yet members (Argentina, Indonesia, Saudi Arabia, South Africa and Turkey) as well as Hong Kong and Singapore. Similar steps were taken by the International Organization of Securities Commissions (IOSCO) and the Committee on Payment and Settlement Systems (CPSS).

The reforms on ‘voice and representation’ of developing countries in the BWIs predate the creation of the G20 at the leaders’ level, and have continued to take place partly on a parallel track. However, there is a clear consensus that one of the signals of success or failure of the G20 would be its capacity to complete this process, including solving the problems of both significant underrepresentation (Asia) and overrepresentation (Europe). In April 2008, a modest agreement was adopted on reforming quotas and votes in the IMF Board, which implies a redistribution of the quotas and a tripling of the basic votes to increase the voting rights of developing countries (including the emerging economies) by 2.7 per cent as a whole. However, the reform has still not been ratified. Ministers from the developing and transition countries asked in the meetings of spring 2010 for an ambitious additional realignment of quotas. This would imply an increase of 7 per cent

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in the quotas of developing countries, based on giving greater weight in the quota formula to GDP measured at purchasing power parity and an appropriate measure of the volatility that different countries face. To these we must add the important proposals made on various occasions, but particularly by the 2009 Commission for Governance Reform, headed by Trevor Manuel: to reduce the threshold of votes needed to approve important political changes in the IMF to be reduced from the current 85 per cent to 70–75 per cent; to create a Council of Ministers with effective powers to adopt the most important political decisions, thus replacing the International Monetary and Financial Committee; and to redefine in a clear way the relations between this Council, the Board and the administration.

For its part, in the spring 2010 meetings, the World Bank approved a transfer of 3.13 per cent of voting power from the developed economies to the developing and transition economies, which will now hold 47.19 per cent of voting power and have received a promise that they will reach parity in the near future. The increases were mainly concentrated in middle-income countries, especially from Asia, which were previously under-represented, while low-income countries saw limited change. This change was achieved through an ad hoc capital increase, not through the agreement on a formula for dynamic revision of capital based on clear principles, including the Bank's development mission. There was an agreement that this would be done by 2015, but developing countries expressed their clear preference for a more ambitious calendar.

The G20 also agreed in spring 2009 that the senior management of these organisations should be chosen through transparent and open processes, based on the merit of the candidates, without their nationality being an issue. It would also be useful for the personnel of these institutions to be more diverse, not just in terms of nationality but also in terms of education and professional experience, as well as gender. It

remains to be seen how these principles will be applied in practice.

The broader issues of global financial governance relate to the G20 itself. The creation of this group at leaders' level is, of course, a step forward compared to the G8, particularly in terms of representation of developing countries. But this solution also created problems because of the ad hoc nature of the cooperation mechanism adopted, including the way in which the membership was defined, which implies the exclusion of some large countries (Nigeria is the case that stands out), and the overrepresentation of Europe. This also reflects the revealed preference by industrial countries for 'Gs', over which they can exercise greater influence.

This preference for 'Gs' over representative global institutions reflects the challenge of overcoming the tension between representativeness and the legitimacy associated with it, on the one hand, and existing power structures, on the other. This issue is sometimes expressed as the tension between inclusiveness and effectiveness, but this is clearly inaccurate, as national democracies have shown that that representative institutions can be effective. At the international level, although the record is mixed, it is unclear whether the G8 has proven more effective than the BWIs or, for that matter, the United Nations. As regards the latter, it can be argued that the United Nations has proven to be a very effective mechanism for consensus building and generation of new ideas and frameworks for international cooperation (for example, the Millennium Development Goals), though its effectiveness has been limited by the tendency of industrial countries to limit its role in the implementation of these agreements. The record of the G8 in terms of effectiveness is probably no better than that of these representative institutions, and in any way both the G8 and now the G20 must act through these institutions.

In this way, although the 'Gs' can play an important role in placing new issues on the agenda and facilitating consensus among major powers, no structure of governance can generate legitimacy



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»»»» as long as decision-making processes are not inclusive. For this reason, the G20 should be seen as a transition to a representative, and thereby legitimate, mechanism of international economic cooperation. One such mechanism would be the Global Economic Coordination Council proposal by the Commission of Experts, convened by the President of the UN General Assembly on Reforms of the International Monetary and Financial System (or, for that matter, previous proposals to create an 'Economic Security Council'). According to this proposal, the Coordination Council would be set in the framework of the UN system, to which the BWIs belong and the WTO should become a member. It would be formed on the basis of constituencies elected through weighted votes, thus

following the model of the BWIs – although with formulas for representation that overcome the problems that those institutions face.

The former Secretary General of the United Nations, Kofi Annan, said in the plenary of the Club de Madrid in November 2009 that the G20 should see itself as a transitional arrangement to a more representative and formal governance structure. This does not yet figure on the G20 agenda. It should be its major concern.

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