



International Cooperation in a Time of Transition

The IMF, G20, and the Global Financial Crisis

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year as President of the G20, given that I have had no professional involvement in this and have no inside intelligence to share.


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Executive Summary


- Through 2008-09, confronted by the risk of global economic catastrophe on a scale not experienced since the Great Depression, the world witnessed intensive efforts at international cooperation and coordination by national governments.
- Under the leadership of the US, G20 Leaders convened for the first time in Washington DC in November 2008 and over the next twelve months and two further meetings, established itself as the premier forum for international economic cooperation. Of more immediate importance, the joint pronouncements of G20 Leaders were successful in putting a floor under hitherto plummeting global economic confidence. Leaders reaffirmed their collective commitment to core principles of ‘...market principles, open trade and investment regimes and effectively regulated financial markets’. Political cover was provided for substantial fiscal and monetary stimulus. A detailed plan of action for refining financial market regulation was agreed with concrete processes for ensuring its delivery. And the International Monetary Fund (IMF), widely dismissed as increasingly irrelevant on the eve of the crisis, re-emerged as the institutional core of international economic governance, with a trebling of its resources — and the commitment of its main stakeholders to ambitious governance reform.
- The subsequent track record, in bureaucratic parlance, has been mixed. Why?

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- Cooperation among sovereign states requires strong leadership and an agenda which resonates with domestic constituencies. The governance model established at Bretton Woods in 1944 produced an elegant merger of legitimacy and the prevailing political realities — specifically, the need for strong US ownership and leadership. Today's multi polar world, in which the US remains indispensable but no longer enjoys its earlier dominance and faces a domestic constituency far less interested in global leadership, is more challenging. Other key players are distracted (Europe) or come to the table with considerable caution, limited capacity and — outside of governance reform itself — a largely defensive agenda (the Emerging Market Economies (EMEs)).
 - Implementation of financial sector reform, arguably a relative success story, is nonetheless confronting mounting difficulties associated with the complexities involved ('too big to fail'), and domestic sensitivities. The Financial Stability Board (FSB) has provided a voice for EMEs, largely used to resist 'unintended consequences', but the agenda has become distracted by the Euro Area's problems, and remains excessively hostage to national competitiveness rivalries.
 - An ambitious reform agenda for the international monetary system only proved a distraction to achieving more pragmatic objectives, as its proponents failed to anchor these efforts on tangible outcomes whose benefits clearly warranted the erosion of national sovereignty. Governments were not persuaded that the system was sufficiently broken. Proposals for a Global Financial Safety Net (GFSN) and for reform of the (\$US based) reserve currency system each met with deeply entrenched resistance to centralized global solutions; there was no appetite for fostering a nascent global central bank. And the outcomes regarding the GFSN, namely further piecemeal reform of the IMF's lending tool



kit, underscored the tendency of the pressure for 'deliverables' to produce messy, least worst outcomes.

- Continuing efforts to improve policy surveillance and coordination offer a more practical way forward. However, the failure of efforts to strengthen or leverage off the IMF's soft 'rules based' approach provide a reminder that international 'rules' cannot make up for a lack of political buy in. The G20's Mutual Assessment Process (MAP), an experiment in a voluntary cooperation, offers more hope of tapping into the essential political ownership. Participants should avoid asking too much of the MAP as efforts continue to strengthen its processes, build trust, and avoid the pitfalls of inflexible targets, indicators, and preoccupation with bilateral disputes.
- Meanwhile, the governance reform agenda, aimed at recognizing the growing weight of the EMEs, is at risk of stalling. The US and Europe have retained their anachronistic hold on the appointment of the senior leadership of the IMF and World Bank, while efforts to strengthen ministerial oversight of the IMF have been stymied by the EMEs, suspicious of distractions from what they see as the core agenda, a realignment of voting shares and representation. US failure to date to deliver on the IMF Quota reform package it championed is threatening progress on other elements of the package. And fundamental conceptual and political differences stand in the way of any underlying reform of the IMF's quota formula. This is understandably increasingly frustrating for EMEs, who are also being asked to play a bigger role in funding the IMF's operations. The prospects for revitalizing a holistic governance reform agenda appear slim. Progress is likely to require efforts to press on with piecemeal compromise and second best political fixes.

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- The world is undergoing a protracted, and uncertain, transition in terms of shifting economic and political weight; the capacity for sustained leadership has been eroded, while the number of stakeholders with an effective veto has expanded. It is essential to build on the promise of the G20, ensuring all the key voices are at the table, to address cross border risks and challenges which are not likely to go away. But the G20 is itself constrained by the realities of the multi polar world, in which the EMEs are feeling their way, suspicious of perceived threats to national sovereignty, and testing the limits of their shared interests.
 - The biggest risk is therefore that of inertia. If the longer term promise of the G20 is to be met, its agenda should not be overburdened or ambitions set too high. Rather, it should focus on achievable and tangible goals, preserving the interest of Leaders but tempering ambition with pragmatism and carefully navigating a path through bilateral disputes and domestic sensitivities.

Section I

Introduction

The concept of ‘international governance’ is, almost by definition in a world in which ultimate authority rests with sovereign states, an amorphous one. The term ‘international governance arrangements’ loosely refers to the various institutional structures, both formal and informal, which have evolved to assist national governments to liaise on emerging issues of common interest, to promote common values and norms of behavior and, where desirable, to help facilitate coordinated and collective action to manage potential cross border spillovers from national policy settings. The mix of institutional structures in the financial sphere has evolved as much as a result of political expediency and compromise in response to changing conditions and periodic shocks as from any agreed overarching vision.

At the center of these institutional arrangements is the International Monetary Fund (IMF), a rules based organization founded on a formal legal agreement¹, with near universal membership, and a highly professional staff which (rightly) prides itself on its technical expertise. Founded at the end of the Second World War, the Fund’s role has evolved from one of managing a system of fixed exchange rates prior to 1971, to one of promoting monetary stability and assisting orderly macroeconomic adjustment in the world of far greater exchange rate flexibility which has prevailed since.

It is not the only player. Other formal international institutions play (or aspire to play) complementary (or sometimes competing) roles of varying degrees of importance², while there are also a range of

1 IMF, *Articles of Agreement of the International Monetary Fund*, (IMF, 2011)

2 These include the Bank of International Settlements (BIS), as well as the Multilateral Development Banks, the World Trade Organization (WTO), the OECD, and even the UN’s Economic and Social Council (ECOSOC).

informal groupings which have an interest in international financial matters. The latter include regional groups such as 'ASEAN plus 3' (the three being China, Korea and Japan) which spawned the Chiang Mai Initiative³, an expression of discontent with the performance of the IMF during that crisis. Most importantly, however, such informal groupings include the G7/8 and more recently the G20, involving the officials, Finance Ministers, and, most importantly, Leaders, of a sub group of systemically large and influential countries.

While the IMF constitutes the mainstay of the formal at international economic governance efforts — built on legal and technocratic foundations — the G7/8, and latterly G20, represent the importance of leadership firmly founded in the real politic of international economic relations. Understanding the complex and sometimes uncomfortable interplay between these two dimensions is central to understanding the experience of the last five years, as

governments sort to respond to the most significant crisis to threaten the global economy since the Great Depression.

On the eve of the collapse of Lehman Brothers, in September 2008, there was a substantial body of commentary and literature documenting the weaknesses of the existing international financial governance arrangements. Moreover, there was considerable underlying agreement on both what was wrong and what needed to be fixed. And getting the right balance between the weight to be placed on legal/technocratic elements and those of a more real politic nature was at the heart of much of this critique and proposed reform agenda. Put slightly differently, it was recognized that the effectiveness of international governance — in a world of states that are equally sovereign but very unequal in terms of economic and political weight — requires both political legitimacy in the eyes of all states, and strong ownership by the big players to make it work.

3 A system of bilateral swap arrangements between members put in place in the aftermath of the 1997-98 Asian Financial Crisis, to provide mutual support in the face of a liquidity crisis, since multilateralized and now totaling \$US 240 billion.

There were two key strands in this broadly shared agenda.

First, the need for wide ranging reform of the IMF. While few disputed its central role in facilitating cooperation on international financial and monetary issues, questions regarding its effectiveness had emerged in the context of its response to a succession of financial shocks to member countries through the 1990s and early part of this century.⁴ Moreover, as the global economy emerged from the crises of the 1990s into a prolonged period of relative stability and growth, the Fund also confronted dwindling demand for its lending, and growing skepticism regarding its continued relevance. By the middle of the last decade, it was generally accepted that the Fund faced a significant identity crisis, reflecting questions about its role and capacity to address the challenges of the new century. Increasing globalization brought increasingly complicated problems requiring increasingly sophisticated cross border solutions. Interest in

regional approaches and solutions gained momentum, as evidenced by the Chiang Mai Initiative referred to above. And fundamental weaknesses in the Fund's governance were widely seen as central to its shortcomings in tackling such challenges.⁵

The second strand focused on the search for more effective means of political leadership and coordination, across the Fund and other relevant institutions, to bring a holistic approach to international governance. The strong ownership of key players needed to be assured if desired outcomes were to be delivered. The G7/8 (consisting of the United States, Japan, Germany, France, United Kingdom, Italy and Canada, and, for Leaders' meetings, Russia) had hitherto sought to play this role, but its membership clearly did not reflect the emergence of new, systemically important players and the dramatic and seemingly inexorable shift of economic and political weight towards Asia. At a minimum, effectiveness demanded

4 Mexico (1994-95), East Asia (1997-98), Russia (1998), Brazil (1998), Argentina (2001) Turkey (2001)

5 See, for example, Edwin M. Truman, ed. *Reforming the IMF for the 21st Century*, Institute for International Economics, 2006

that membership of the political steering group for international economic and financial governance in the new century include the key emerging market economies. Some went further, however, and made a case for more holistic attempts to ensure that any expanded group function as a 'Global Apex Organization', providing coherent and coordinated leadership across the full range of cross border challenges — economic, environmental, and strategic.⁶

The financial crisis which shook the world in 2008, was unprecedented in the period since the Second World War, and was matched initially by equally unprecedented efforts to coordinate extraordinary national policy responses. There is no doubt that the ensuing Great Recession could have been far worse in the absence of such a collective response by systemically important economies. Nevertheless, the subsequent track record of sustained cooperation has fallen short of the hopes many had at the time.

Moreover, the crisis (including its subsequent metamorphosis into the Euro Area sovereign debt crisis) has served to underscore the underlying structural shifts in global economic weight that increasingly cast doubt upon the efficacy of the existing governance structures. It started in the United States, the world's largest and most advanced economy, challenging the popular preconception that structural weaknesses sufficient to pose significant systemic risk were the preserve of emerging market economies. The revelation of equally serious structural weaknesses in the Euro Area has only further weakened the moral authority of the advanced economies — and the values embedded in the policy frameworks they espouse. In an increasingly multi-polar world, in which economic influence and weight is more equally shared between a number of sovereign states, including the emerging markets, this challenge to the appeal of 'core' values necessarily further complicates the dynamics of collective action. In this context, the emergence of key emerging markets as significant

6 Colin I. Bradford Jnr and Johannes F. Linn, "Global Governance Reform: Conclusions and Implications" in Colin I. Bradford Jnr. And Johannes F. Linn, eds., *Global Governance Reform: Breaking the Stalemate*, Brookings Institution Press, Washington D.C., 2007, pp 127-130

net creditors in the overall system provides a very tangible lightning rod for such tensions.

The crisis has been a catalyst for a number of significant developments in international financial governance arrangements.

Most importantly, we have seen the establishment of the G20 Leaders' process, and its efforts to establish itself as the premier body for international economic cooperation.⁷ The Financial Stability Forum (FSF), a creature of the G7, has been transformed into the Financial Stability Board (FSB), a creature of the G20 with enhanced representation and accountability for progressing extensive agreed reforms of financial regulation. And significant commitments were made to rekindle a far reaching reform agenda for the IMF, whose relevance has been reaffirmed — even if its effectiveness may continue to be disputed.


In what follows, I aim to offer some

personal reflections — from the perspective of someone who has been a sometime practitioner in international financial governance over the last two and a half decades, and in particular closely involved in events over the period 2008-12⁸ — on what developments over this recent period may tell one about the nature of international financial governance, including both its limitations and the constraints on reform.

It has been a period of intense activity as policy makers have wrestled with persistent global imbalances, the immediate challenges of crisis management, and the imperative of cementing and strengthening a grudging global economic recovery. There have been strong statements of shared political agreement on the need for reform, with progress on a number of fronts. Nevertheless those that hoped for significant holistic reform to the existing international financial governance institutions will have been disappointed. It is important

7 *G20 Leaders' Statement*, The Pittsburgh Summit, September 24-25, 2009, paragraph 19

8 Between November 2008 and end October 2012, I served on the Executive Board of the International Monetary Fund, first as Alternate Executive Director and then, from November 2010, as Executive Director representing a constituency of 15 countries, of which the two largest were the Republic of Korea and Australia. Prior to that, in a thirty year career with the Australian government, I have served as an Assistant to Australia's IMF Executive Director,



to ask ourselves why this is the case, and what it means for establishing realistic expectations of continuing reform efforts in the current circumstances.

The Sections that follow first provide an overview of the evolution of main elements of the international governance arrangements in place on the eve of crisis, alongside a summary of the growing chorus for reform. Section III recounts the events of 2008-09, as governments demonstrated a willingness to consider exceptional collective efforts as the enormity of the threat posed by the crisis became clear. In Section IV, I explore the subsequent challenges of delivering on specific commitments — in particular, the initial ambitions for broad ranging reform of the international monetary system, the related issue of enhancing Fund surveillance, and reforms to IMF governance. The final Section offers some concluding observations.



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Section II

International Economic Governance on the Eve of the Financial Crisis

a System Under Challenge

THE BRETTON WOODS MODEL

The 1944 Bretton Woods Conference remains the pinnacle of twentieth century collective government action in the spheres of international financial and economic relations.

It is worth noting the unique set of circumstances that led to the remarkable success of the Conference. Most importantly, the participants came with a shared determination to avoid the pitfalls of the 1918-39 period — the disorderly collapse of the Gold Standard, the failure of policy to first avoid and then mitigate the effects of the 1929 stock market crash, and subsequent beggar thy neighbor policies, including

competitive devaluations and a rise in protectionism, which all helped put the 'Great' into the Great Depression. They did this in the shadow of the extraordinary destruction and suffering wrought by a second global war within a generation, which clearly helped concentrate the mind and place national interests in a broader perspective. And they had the benefit of the extensive preparatory work and coherent leadership provided by the United States and United Kingdom Governments, — which, in the case of the US, reflected a strong commitment to building a multilateral set of rules which would best match US interests in an open global trading system and avoid the damaging bilateralism that had preceded the war.⁹

9 See, for example, R.N Gardner, *Sterling-Dollar Diplomacy*, (Oxford University Press, 1969), and Armand Van Dormeal, *Bretton Woods; Birth of a Monetary System* (MacMillan Press, 1978)

In just a little over three weeks in July of that year, the forty-five¹⁰ participating delegations agreed the Articles of Agreement of the International Monetary Fund, to be the institutional cornerstone of international Financial cooperation, along with those of the International Bank for Reconstruction and Development (to become known as the World Bank), while laying the foundations for the General Agreement on Tariffs and Trade (GATT), later to evolve into the World Trade Organization.

Over the succeeding sixty-nine years, the IMF has faced numerous challenges and has been no stranger to criticism. While its reputation and standing has waxed and waned, it has retained the active participation of its members. Its broad objectives remain highly relevant, and it continues to offer member states the benefits of a relatively effective multilateral forum in which to tackle cross border financial and economic policy issues. Its staff's technical expertise remains widely,

and highly, respected. Indeed, as international organizations go, the Fund (along with the World Bank) is an exemplar of durability, adaptability and effectiveness.

Nonetheless, the Fund is also testament to just how challenging the task of international 'governance' is, and in particular the difficulty of codifying a rules-based approach to international cooperation.

Article I of the Fund's Articles clearly sets out the objectives of the institution. It is charged with promoting international monetary cooperation, and establishing a multilateral payments system supportive of the expansion and balanced growth of international, and unrestricted, trade, to underpin high levels of employment, income and the development of its members' productive resources. Specifically, it is to promote exchange stability — including the avoidance of competitive exchange rate depreciations — and give confidence to members facing external imbalances, and minimize

10 There were delegations representing the forty-four members of the United and Associated Nations, plus a representative of Denmark, which did not have a recognized government in exile at that time.

the associated disequilibrium, by making resources available to them in support of orderly adjustment policies which avoid 'measures destructive of national or international prosperity'.¹¹

While intended as the financial counterpart to a liberalized post-war international trading system, in which there should be no restrictions on current payments, its founders did not include liberalized capital flows as part of their vision for the post-war financial architecture. Rather, the post war resumption of international capital flows was thought unlikely in the foreseeable future, and something to be managed in the longer term¹². The IMF's founders understood that there was an inherent tension between a system of fixed exchange rates and unrestricted capital mobility. Article VI of the Fund's Articles explicitly allows recourse to capital controls, consistent with the view that the

risks associated with financial integration should be constrained in the interests of governments' capacity to independently pursue broader domestic policy agendas.

In the event, it was the explosion in private capital flows in the second half of the twentieth century, which brought the system of fixed exchange undone. The Second Amendment¹³ to the Fund's Articles, which took effect on April 1, 1978, codified fundamental changes to the international monetary system and the role of the Fund as a result of the collapse of the fixed exchange rate system. Most importantly, the Second Amendment acknowledged members' rights to opt for greater exchange rate flexibility. It affirmed the breakdown of any formal efforts to manage the inherent tensions between capital mobility, fixed exchange rates and the pursuit of independent domestic monetary policy. Instead,

11 IMF, Op.cit. 2011

12 Harold James, *The Creation and Destruction of Value: the Globalization Cycle* (Harvard University Press, 2009), pp26-27

13 The First Amendment, which took effect in July 1969, created the Fund's Statutory Drawing Right (SDR) in response to concerns about a growing scarcity of reserve assets. However, the SDR has since been of relatively little systemic importance in international financial relations, other than as a unit of account for the Fund's operations, notwithstanding the decision to allocate \$250billion in SDRs to Fund members as part of the initial crisis response in 2009.

it emphasized the role of Fund surveillance of members' policy settings, aimed at encouraging, through a mix of peer pressure and international legal 'obligation', stability in a more uncertain and potentially disorderly world.

The difficulties of capturing such a world in legally binding language is reflected in the key obligations embedded in the Articles. Outside of those relating to operational issues, these primarily reside in Articles IV and VIII.

The first of these relates specifically to members' obligations in support of the Fund's stewardship of the international monetary system and its responsibility to conduct surveillance of members' domestic economic policies. Members are required to collaborate with the Fund to "...assure orderly exchange arrangements and to promote a stable system of exchange rates."¹⁴ Specific obligations involve *endeavoring* to ensure that domestic policy settings are aimed at achieving "...orderly

economic growth with reasonable price stability"¹⁵, and *seeking* to promote stability by "...fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions."¹⁶ The only clear obligation regarding the Fund's bilateral surveillance which is not couched in 'best endeavors' terms is that requiring members to avoid manipulation of exchange rates or the international monetary system,¹⁷ but even here, definitive understandings are elusive. Precisely what 'manipulation' might mean is understandably vague, other than references to preventing *effective* balance of payments adjustment and seeking to gain an *unfair* advantage over other members. Section 3 of Article IV deals with the Fund's responsibility to oversee the international monetary system as a whole (multilateral surveillance), and imposes a firm obligation on members to consult with the Fund regarding relevant policy settings when requested.

14 IMF, Op.cit, (2011) Article IV, Section 1

15 Ibid, Article IV, Section 1 (i)

16 Ibid, Article iv, section 1 (ii)

17 Ibid, Article IV, Section 1 (iii)

Article VIII provides more specificity regarding the information members must provide to the Fund to allow it to carry out the surveillance role set out in Article IV. It also requires members to avoid restrictions on current payments, respect the exchange controls of others where they are imposed consistent with the Fund's Articles, in particular Article VI relating to capital controls, avoid discriminatory currency practices, and preserve currency convertibility, although Article XIV allows for transitional arrangements with regard to exchange restrictions pending a member's acceptance of the requirements of Article VIII.

These 'legal' obligations need to be understood in the context of a governance structure which explicitly acknowledges the asymmetries inherent in the distribution of economic and political weight and influence. The participants at Bretton Woods were confronted by a difficult balancing act — crafting a governance structure which met the need for legitimacy, based

on a voice for all members, with recognition of the *realpolitik* of the post war era in which the US was the dominant economy, exporter and creditor. The intrinsic strengths of the model they adopted explains much of the Fund's relative success and continued relevance over the years, referred to above, in the eyes of its members. In particular, it owes much to a strong dose of Morgenthau-like international relations realism.¹⁸

In brief, a member's votes in the IMF — the major determinant of its influence over Fund decisions — vary according to the member's relative position in the world economy. Each member is allocated a quota, which both determines the member's contribution to the pool of international reserves available to the IMF to lend to members facing a balance of payments funding need, and acts as a reference point for the member's potential access to Fund resources in such circumstances. Quotas are decided with reference, albeit loosely, to objective benchmarks,

18 Hans Morgenthau is generally seen as the father of the 'realist' school of international relations as outlined in his seminal work, *Politics Among Nations* (1949). See for example, Francis A Boyle, "The Irrelevance of International Law: The Schism between International Law and International politics," in *California Western International Law Journal*, Volume 10, 1980, pp 193-218.

such as a member's relative GDP and share of world trade, and members' relative voting power is determined in line with their quotas. At the same time, the need for all members to have a guaranteed voice, irrespective of size, was met by a uniform allocation of 'basic votes' to all. By 2008, the relative weight given to this element, which had remained unchanged at 250 votes per member, had been allowed to erode significantly.

There were a number of other key elements in the governance arrangements and practices designed to contribute to this careful balance. First, while most decisions require only a simple majority of the voting power, special majorities are required for selected systemically important decisions. In particular, at least 85 percent of the voting power of the membership must endorse any change to the Articles, increase in quotas, change in the size of the Executive Board, or key matters relating to the valuation

and allocation of Special Drawing Rights (SDRs). Selected key operational and financial decisions require a 70 percent majority. Second, the Executive Board, to which the Governors¹⁹ of the Fund have delegated most day to day decision making powers, quickly established the convention that formal votes should be avoided, and rather to seek to operate on the basis of consensus.²⁰ (However, consensus is not interpreted as unanimity but rather the Chair's sense of discussion such that the required majority, were a vote to be taken, could be comfortably obtained. The Chair has considerable scope to vary the required comfort level, depending on the sensitivity of the issue being decided.)

Initially consisting of twelve Executive Directors, the Executive Board has since grown to twenty-four. The Articles allow the five members with the largest quotas to directly appoint an Executive Director; the remaining Directors are elected every two years by constituencies of members,

19 Each member appoints a Governor for the Fund, usually the Minister for Finance or equivalent, or Central Bank Governor. Formal power rests with the Board of Governors, consisting of the Governors of the full membership.

20 Joseph Gold, "The Institution," in J. Keith Horsefield (ed.) *The International Monetary Fund, 1945-1965, Volume II: Analysis* (IMF, Washington DC, 1969), pp 516-518

reflecting idiosyncratic groupings based on some combination of geography and politics. Under the Articles, Executive Directors are not formally 'representatives' of the governments that appoint or elect them. They are officers of the Fund, and have a degree of freedom to refine the appropriate balance to be struck between their fiduciary responsibility to the institution and the allegiance they owe their national authorities, a balance that can vary chair by chair and issue by issue.²¹

The main elements of the Fund's governance model, therefore, include: a clear link between economic and political weight and voting power while ensuring a voice for all members; and conventions that allow the members of the key decision making body, the Executive Board, scope to manage the necessary interplay of technical and political considerations in articulating the views of the membership, while showing appropriate respect to the apolitical spirit of the Fund's mandate.

In all of this, a degree of creative ambiguity has allowed the necessary room to manage tensions as they arise. However, it must be said that such ambiguity has also been allowed to sow the seeds of future problems. The prime example is the fact that the link between voting, quotas and economic and political weight, while always clearly understood as central to the model, has never been precisely defined. The principle is not explicitly acknowledged in the Articles, and the relationship between quotas and benchmarks such as GDP, trade flows, etc, has been, at best, a fluid one. The original allocation of quotas agreed at Bretton Woods reflected the political judgment of the head of the US Delegation, Harry Dexter White, that the US, as clearly the world's dominant economy emerging from WWII, should have approximately a third of the voting power and twice that of the next largest member, the UK, that the US and UK combined should have just under half the total voting power, that the US vote

21 Ibid.

should exceed that of the British Empire members, and that the USSR and China, should make up, with the US and the UK, the four largest members. A quota formula was devised to justify such an outcome, but never discussed and indeed, never formally shown to other delegations. Rather, the mere fact of being able to claim the existence of such a formula was used to head off protracted technical discussions²².

Such 'rough justice' no doubt produced the right outcome for the time. The subsequent evolution of the Quota formula(e) through successive Quota reviews has been a story of a quest for spurious precision, with the associated inevitable trade of between complexity and transparency. Ironically, this has played out in the context of persistent reluctance to actually apply the agreed formula. (See Box II-1)

22 See J. Keith Horsefield (ed). Op.Cit, p 95

Box II-1: Evolution of the IMF Quota Formula and its Application

The Fund's Articles of Agreement require a General Review of quotas, that is, the size of the IMF and the issue of how any increase should be allocated between members, at least every five years.

The original Bretton Woods formula produced a member's calculated quota as a function of their national income, gold and foreign exchange reserves holdings, average annual exports and imports (each based on a five year average), and the maximum fluctuation in exports, defined as the difference between the highest and lowest values over the relevant five year period. It was used as the basis for the initial allocation of quotas, but subsequently not applied in any of the following three five yearly reviews, each of which determined that a general increase in the level of quotas was not warranted. A 60.7% increase in quotas was agreed in 1958/59, outside the normal cycle of general reviews, with the great bulk to be distributed to all members in proportion to their existing quota shares, with additional ad hoc increases for selective members.

In 1962/63, a multi-formula approach was adopted, involving the addition of four variations on the original formula, modifying both weights and variables and applying each to two distinct data sets. The ten calculations were then used to produce both a calculated quota range and a point estimate. The primary objective was to produce somewhat higher calculated quotas for smaller and more open economies. In 1983, the multiple formulae were further revised, with a significantly greater precision for the weights used – in some cases, extending to nine decimal places! – and one of the data sets was dropped. The resulting formulae were used through to the eleventh General Review of Quotas, completed in 1998, the last review prior to the Global financial crisis to agree an increase in quotas.

In 2008, the current single linear formula was agreed, as part of agreements reached to begin a process of re-aligning members'

quota and voting shares with changing relative economic weight. The formula is as follows:

$$CQS = (0.5*Y + 0.3*O + 0.15*V + 0.05*R)k$$

where CQS is the Calculated Quota Share; Y is a 60/40 blend of market exchange rate and PPP based GDP; O is 'openness', measured as the annual average of the sum of current payments and receipts for a five year period; V is the variability of current receipts and net capital flows, measured as the standard deviation from a centered three year trend over a thirteen year period; R is the average level of a county's holdings of official international reserves over a year; and k is a compression factor of 0.95 percent

However, in practice the evolving formula has had relatively limited impact on actual quota shares. The following table shows that in all but one quota increase through to the eleventh Review, there was a significant – and in most cases dominant – equiproportional increase, based on existing shares.

Ratio of Equiproportional to Selective/Ad hoc Quota increases

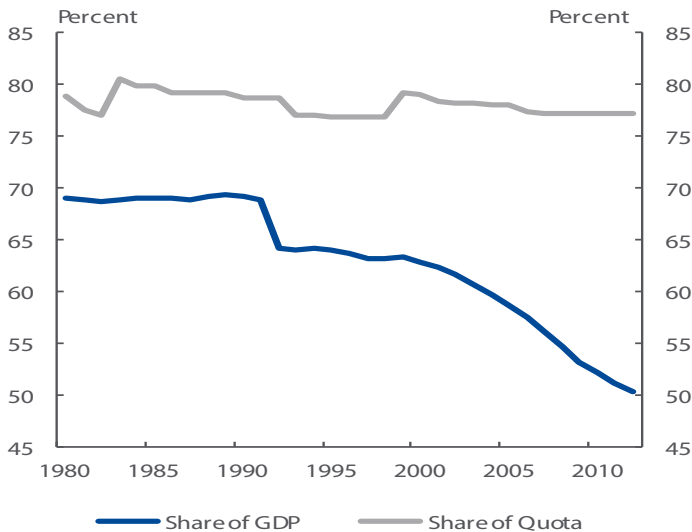
1958-59	1965	1970	1976	1978	1983	1990	1998
	Fourth General Review	Fifth General Review	Sixth General Review	Seventh General Review	Eight General Review	Ninth General Review	Eleventh General Review
82:18	81:19	70:30	0:100	98:2	40:60	60:40	75:25

As a result, both quota (and voting) shares and Executive Board composition have evolved over the history of the Fund, but the link to changing political and economic realities has been imperfect, and subject to significant lags and various ad hoc adjustments.

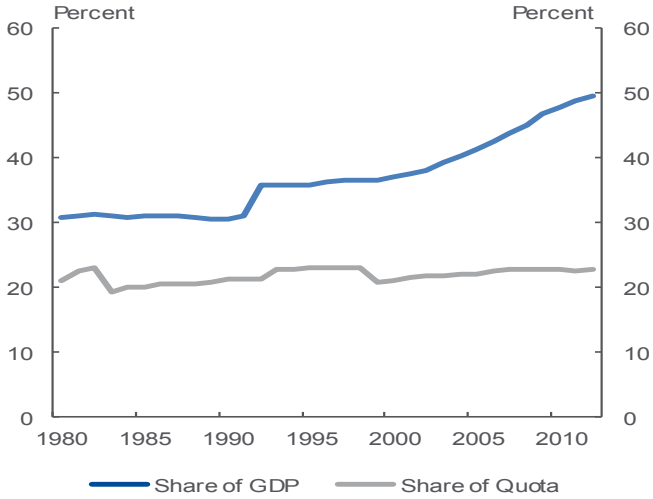
Chart II-1 shows the evolution of quota shares for key groups of members since 1980, relative to their share of GDP, while Table II-1 shows how similar trends have been reflected in the evolution of representation for the current membership of the G20.

CHART II-1: IMF QUOTA AND WORLD GDP (PPP) SHARES OVER TIME

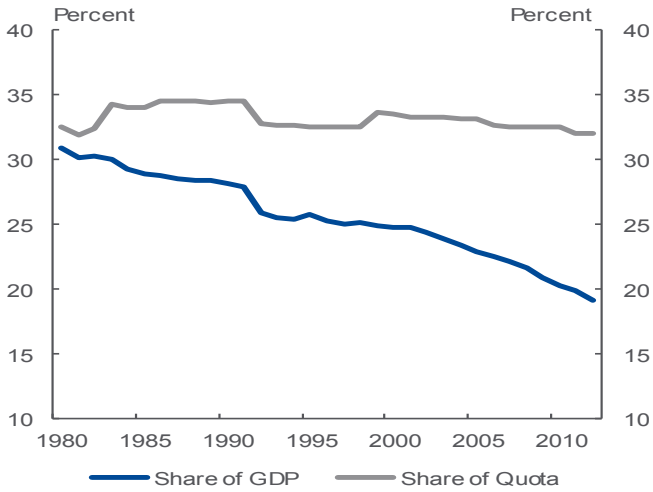
Advanced Economies



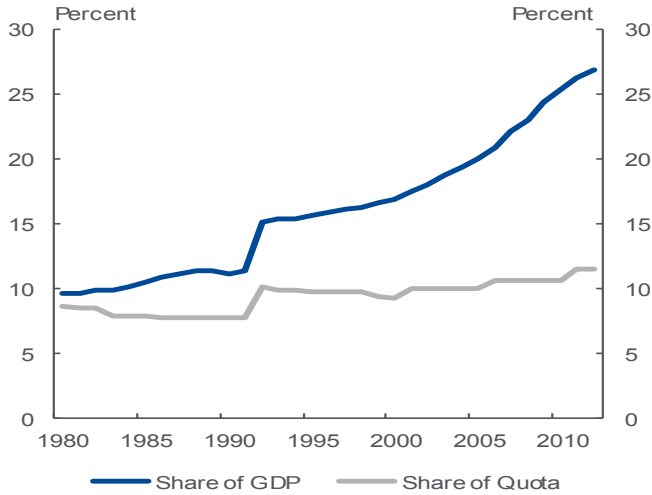
Emerging Market and Developing Economies



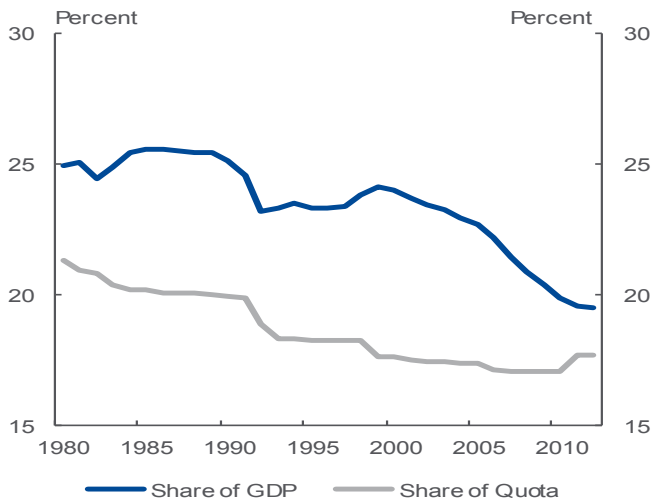
European Union



Brazil, Russia²³, India, China, South Africa



United States



Source: IMF International Financial Statistics; IMF World Economic Outlook, October 2013

Notes: GDP shares are based on purchasing-power parity (PPP) valuation of country or group GDP.

23 The Russian Federation formed on 25 December 1991 and joined the Fund on 1 June 1992

TABLE II-1: G20 REPRESENTATION AT THE IMF EXECUTIVE BOARD AND VOTING SHARE

Country	1960			1976			1996			2012		
	Board Position	Voting Share (%)	World GDP Share (%)	Board Position	Voting Share (%)	World GDP Share (%)	Board Position	Voting Share (%)	World GDP Share (%)	Board Position	Voting Share (%)	World GDP Share (%)
Australia	Director	2.71	1.50	Director	2.13	1.39	Director	1.58	1.42	Director	1.31	1.55
Canada	Director	3.73	2.52	Director	3.47	2.56	Director	2.91	2.36	Director	2.56	2.30
France	Director	5.34	5.66	Director	4.70	5.82	Director	4.98	4.97	Director	4.29	4.13
Germany	Director	5.34	na	Director	5.01	8.03	Director	5.54	7.03	Director	5.81	5.64
Italy	Director	1.83	4.92	Director	3.16	5.06	Director	3.09	4.46	Director	3.16	3.17
Japan	Director	3.39	7.13	Director	3.78	10.54	Director	5.54	12.07	Director	6.23	8.65
Russia ²⁴	-	-	-	-	-	-	Director	2.90	1.44	Director	2.39	1.80
UK	Director	13.23	7.69	Director	8.71	5.48	Director	4.98	4.92	Director	4.29	4.39
USA	Director	27.92	30.42	Director	20.73	26.76	Director	17.78	27.63	Director	16.75	26.12
Argentina	Director	1.90	0.69	Director	1.43	0.54	Alternate Director	1.05	0.44	Director	0.87	na
Brazil	Director	1.90	1.37	Director	1.43	2.09	Director	1.47	2.02	Director	1.72	2.09
China ²⁵	Director	3.73	0.91	-	-	0.80	Director	2.28	2.94	Director	3.81	8.30
India	Director	4.07	1.12	Director	2.97	0.91	Director	2.06	1.37	Director	2.34	2.51
Indonesia	Director	1.12	0.28	Director	0.88	0.30	Director	1.02	0.67	Alternate Director	0.85	0.78
Mexico	Constituent	1.22	1.39	Constituent	1.22	1.79	Constituent	1.19	1.89	Director	1.47	1.90
Saudi Arabia	Constituent	0.37	na	Constituent	0.49	0.87	Director	3.45	0.67	Director	2.80	0.91
South Africa ²⁶	Constituent	1.02	0.64	-	1.06	0.66	-	- ²⁷	0.53	Constituent	0.77	0.56
South Korea	Constituent	0.13	0.40	Constituent	0.32	0.66	Alternate Director	0.55	1.67	Director	1.37	1.98
Turkey	Constituent	0.58	0.70	Constituent	0.54	0.82	Constituent	0.45	0.97	Constituent	0.61	1.15
Total ²⁸		79.53	67.34		62.03	75.08		62.82	79.47		63.39	77.93

-
- 24 Russia joined the Fund on 1 June 1992.
- 25 China was a founding member of the IMF, first represented by the Nationalist Republic of China (ROC) Government which had governed only the Taiwan Province of China but had claimed to represent the entire country for more than 30 years. The People's Republic of China (PRC), residing in, and controlling, mainland China, had also claimed to represent all of China. Because the majority of the Fund membership did not yet recognize the PRC as the legal government of China, the ROC continued to represent China at the Fund. From the years 1973-1980 there was an impasse over the representation of China until 17 April 1980 when the Fund officially recognized the PRC as the government of China, which came nine years after that of the United Nations decision to recognize the PRC as the ruling government of China. See: IMF, *Chapter 19: Towards Universal Membership*, (IMF, 2001), in 'Silent Revolution: The International Monetary Fund 1979-1989', (IMF, 2001).
- 26 From 1948 to 1974, South Africa was a member of the constituency headed by Australia until the Australian government informed the South African authorities that they were no longer welcome in that group. South Africa ceased to participate in elections of Executive Directors, or were represented at the Board, until the country joined the sub-Saharan African constituency group in 1996.
- 27 South Africa did not participate in the 1994 Regular Election of Executive Directors.
- 28 Excluding the EU. Total may vary to the sum of the above figures due to rounding.

Source: UN Yearbooks (1960 and 1976 end of calendar year); IMF Annual Reports (1996 and 2012 end of IMF financial year); World Development Indicators (World Bank).

Notes: World GDP shares in constant 2005 US dollars. Dollar figures for GDP are converted from domestic currencies using 2000 official exchange rates. For more information, see The World Bank, *World Development Indicators*, (2013).

THE EVOLVING QUALITY OF US LEADERSHIP

Bretton Woods arguably reflected a uniquely American faith in the capacity of an international constitution to depoliticize international economic relations and restrict the intrusion of competing nationalisms, albeit under the strong (but presumably enlightened) leadership of the US.²⁹ The story of international financial governance through the second half of the twentieth century is essentially one of the steady erosion of the US's relative economic dominance and its adjustment to the challenges of exercising leadership in a far more pluralistic world.

The First and Second Amendments to the Fund's Articles, which took effect in 1968 and 1978, respectively, consolidated the special majority needed for key systemically important decisions at the current 85 percent, replacing a range of lower thresholds (ranging from two-thirds to four-fifths of

the voting power), thereby giving the US, whose share of total voting power had steadily declined from around 35 percent to 20.4 percent following the Seventh Quota Review in 1978, a more comfortable margin for its veto over such decisions.³⁰ Nonetheless, other groupings of members could realistically increasingly exercise a veto, for example the remaining members of the G10 (the primary group of creditor Fund members to be discussed further below), and from the late 1970s, OPEC with the support of other developing country members.

The period leading up to the 1971 US decision to abandon the convertibility of the US dollar for gold the cornerstone of the Bretton Woods fixed exchange rate system and the subsequent failure of efforts to agree a new system of fixed par values was characterized by increasing friction more broadly in the US trans-Atlantic relations. Economic policy tensions overlaid emerging foreign policy

29 F. Hirsch and M. Doyle, "Politicization in the World Economy: Necessary Conditions for International Order," in Hirsch, Doyle and Morse, *Alternatives to Monetary Disorder*, (McGraw Hill, 1977), p.15

30 See Margaret Garritsen de Vries, ed. *The International Monetary Fund, 1972-1978, Volume I*, (International Monetary Fund, 1985), pp 535-543, and the Executive Board Report to the Board of Governors on "Proposed Second Amendment of Articles Of Agreement, of the International Monetary Fund", (March 1976) in *Ibid*, Volume III (Documents)

differences regarding the Atlantic alliance's positioning vis a vis the Soviet bloc, and the US's expanding entanglement in Vietnam. The subsequent period, through the late 1970s and 1980s, saw the US attempting to bed down a system of floating exchange rates against the background of emerging North-South tensions, and the increasing importance of relations with developing countries. The US approach fluctuated between what some allies considered to be the Carter Administration's naïve internationalism and Reagan's greater focus on bilateralism and benign neglect of the exchange rate (helped by a strengthening US dollar thanks to the combination of fiscal laxity and Fed Chairman's Volcker's hardline monetary policy).³¹ Subsequent financial shocks close to home, in Mexico, Brazil and Argentina, served to rekindle US enthusiasm for its leadership role, at least in crisis management, although the experience during the Asian financial crisis a decade later would lead many in that region to question the US's leadership

commitment and effectiveness.

There were clearly underlying fundamental structural issues that led to the demise of the Bretton Woods fixed exchange rate system, most importantly the unanticipated extraordinary growth in private international capital flows, and the US's difficulty in managing the inherent tension between domestic and international economic policy agendas. However, the declining relative preeminence of the US economy over the period was inextricably linked to the latter, and it has continued to drive periodic soul searching within US policy circles about the limits of its international leadership role and how best that should be exercised in an increasingly constrained environment.

Between 1950 and 2008, US GDP increased by a factor of a little over 6.5, but that of Latin American economies' GDP increased by a factor of close to 10, while that of Japan grew by a factor of 18.³² In the late 1980s, early 1990s, it was the emergence of Japan

31 C.Y. Legg, "Global Leadership in an Interdependent Monetary System; US International Economic Policy and the Private International Monetary Market" Australian National University (January 1984), unpublished

32 Mauro F. Guillen and Emilio Ontiveros, *Global Turning Points: Understanding the Challenges for Business in the 21st Century*, (Cambridge University Press, 2012) p 123.

TABLE II-2: SIZE AND DEPTH OF G-7 CAPITAL MARKETS, 2012 (IN BILLIONS OF US DOLLARS)

	GDP	Stock Market Capitilisation	Total Debt Securities (public and private)	Bonds and Equities (% of GDP)
US	16,245	16,856	35,155	320.2%
Japan	5,960	3,639	14,592	305.9%
UK	2,477	3,416	5,778	371.2%
Germany	3,430	1,567	4,355	172.7%
Italy	2,014	510	3,895	218.7%
Canada	1,821	2,028	2,101	226.6%
France	2,614	1,663	4,530	236.9%

Source: International Monetary Fund, *Global Financial Stability Report*, October 2013, Statistical Appendix, Table 1, page 169

which was the pre-occupation of popular US concerns regarding its relative decline, and in the Fund was the focus of efforts to realign Quota shares consistent with Japan's clear position as the world's second largest economy — something that was achieved as part of the Ninth Quota Review in 1990.³³ More recently, however, attention has shifted to the extraordinary rise of China as the primary counter weight to US

hegemony. China's GDP grew a staggering 36 fold between 1950 and 2008,³⁴ and is widely expected to overtake the US, in purchasing power parity terms, as the world's largest economy within the next year or so.³⁵

There is currently extensive debate under way regarding the implications of China's rise relative to the US. A thorough treatment of this debate is well beyond the scope

33 James Boughton, *The Silent Revolution: The International Monetary Fund, 1979-1989*, (International Monetary Fund, 2001), pp 870-875

34 Guillen and Ontiveros, Op.cit.

35 See, for example, The Australian Government's White Paper, *Australia in the Asian Century*, (2012), Box 2.1, p53

of this paper. Suffice to say, there are a number of good reasons why one might be skeptical about forecasts of an imminent and clear cut passing of the 'global leadership' baton from the US to China. The US's continued clear edge in per capita income terms, its greater potential ability, therefore, to divert resources into the military and other hard power assets, and fundamental questions about China's ability to match the US in terms of 'soft power' — the term coined by Joseph Nye³⁶ to capture the ability to shape the preferences of others by harnessing the appeal of one's culture, ideology and institutions — are all relevant to this judgment.³⁷ In the financial sphere, the fact that no other economy can match the size and depth of the US's capital markets, as shown in Table II-2, is also highly relevant.

Nonetheless, while the US remains the indispensable nation, it has progressively had to play this role in a world in which power and influence are less asymmetrically

distributed among key sovereign states, and in particular to adjust to the rise of emerging market economies of which China is clearly the most significant.

HARNESSING COLLECTIVE POLITICAL LEADERSHIP

This is the context in which the evolution of the IMF, as the formal, technocratic institution at the core of international financial governance, has been matched by the emergence of political level groupings of selected Fund members, of varying degrees of formality, in a search for enhanced collective political leadership.

The first of these, the G10, was a grouping of advanced economy creditor members³⁸ which had agreed to participate in the General Agreements to Borrow (GAB), borrowing arrangements designed to supplement the Fund's resources if required to finance lending to an advanced economy. It quickly evolved in a forum for broader

36 E.G. Joseph Nye, *Soft Power: The Means to Success in World Politics*, (Public Affairs, New York, 2004)

37 Guillen and Ontiveros, Op.cit. pp131-143

38 Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, the United Kingdom, the United States, and Sweden. Switzerland would later join.

policy issues, and also initiated the creation of Working Party No 3 of the OECD's Economic Policy Committee, in which the same membership met to discuss balance of payments adjustment issues for advanced economies. Its creation is credited with beginning the process of polarizing the Fund membership into groups of advanced versus developing country members, catalyzing the emergence of a developing country caucus within the Fund, most importantly reflected in the G24.³⁹ Both the G24 and the G10 still exist, but while the former is moderately active in proselytizing issues of particular interest to its members, the G10 is now largely moribund.

Subsequently, smaller 'Gs' emerged without institutionalized links to the Fund — the G5 (the Finance Ministers of the US, UK,

Germany, France and Japan, also known as the 'Library Group', because of their low key inaugural 1973 meeting in the White House Library), and the later outshoot of this, the G7 (with the addition of Italy and Canada), which met more formally at both the level of Finance Ministers and Leaders commencing in 1977.⁴⁰ In 1998, the G7 was expanded to include Russia at the Leaders' level to create the G8.

From its origins in the mid-1970s, the G7 Finance Ministers process, representing the voice of some 47 percent of IMF voting power⁴¹ and around 64 percent of global real GDP⁴², came to effectively operate as a steering committee on issues relating to the international monetary system. Its membership included all the dominant economies at that time, including Japan which, as noted

39 Alexander Mountford, "Governance of the International Monetary Fund," in Ruben Lamdany and Leonardo Martinez-Diaz, eds. *Studies of IMF Governance: A Compendium* (International Monetary Fund, 2009), pp. 38-40

40 James Boughton, Op.cit. p 187

41 Calculated as of the Eighth General Review of Quotas - the figure was over 50 percent if one included the votes of the other members represented by Canada and Italy on the IMF's Executive Board.

42 GDP in constant 2005 US dollars. Dollar figures for GDP are converted from domestic currencies using 2000 official exchange rates. For more information, see The World Bank, *World Development Indicators*, (2013).

earlier, was then seen as the most likely potential challenger to the US's leadership role. Moreover, as a relatively small club of US allies with broadly shared democratic values, it was able to establish informal and collegial forms of interacting which proved more effective than the more formal interactions through the IMF's Executive Board.⁴³ Through the 1980s it was central to efforts to coordinate macroeconomic policy settings, and achieve 'desirable' exchange rate alignments in the new 'floating exchange rate' world, through a judicious mix of joint public policy commitments and concerted central bank foreign exchange intervention, albeit with debatable results.⁴⁴ Over time, the agenda broadened significantly, especially for Leaders' meetings, but international financial and economic issues remained at the core of the continuing G7 Finance Ministers' process. In the context of the Ninth General Review of IMF Quotas, it was notably the

G7, not the Fund's Executive Board, which brokered the deal necessary to elevate Japan to the relative position in the Fund that matched its standing in the world economy.⁴⁵

The G7's determination to avoid an institutional link to the IMF is noteworthy. From the earliest days of the Fund's engagement with the G7's nuclei, the G5, it was made clear that the invitation to the Fund's Managing Director to attend was extended to him in his personal capacity,⁴⁶ and this philosophy was to broadly prevail through the subsequent evolution of the G7 (and indeed continues to apply in spirit to the MD's attendance at G20 meetings). It was, from all accounts, an understanding that had an appeal to both the G7 and the MD. It allowed the MD flexibility to speak his mind, without any obligation to consult first with, or report back to, the Fund's Executive Board, and it assured the G7 a degree of

43 Gordon S. Smith, "G7 To G8 To G20: Evolution in Global Governance," CIGI G20 Papers No.6, May 2011 (The Centre for International Governance Innovation.)

44 Mark Sobel and Louellen Stedman "The Evolution of the G7 and Economic Policy Coordination," Occasional Paper No 3 (US Treasury, July, 2006)

45 This deal involved reaching an agreement between the UK and France on distributing the burden of the necessary adjustment

46 James Boughton, Op.cit. p 194

flexibility in how they managed their engagement on Fund issues.

It is also noteworthy that, as the G7's influence became more prominent, enthusiasm waned for proposals to establish a Ministerial decision making body as part of the formal governance structure of the IMF. The Second Amendment to the Fund's Articles made provision for the creation of a Council of Ministers, mirroring the composition of the Executive Board, with the ability to exercise the decision making powers of the Board of Governors on selected issues. In 1974, the ironically named 'Interim Committee' — an advisory committee of Ministers of the same composition — had been established to provide political guidance to the Executive Board through the expected period of transition towards a new system of stable par exchange rates, pending the activation of the Council. The name proved ironic because the Interim Committee was to become a fixture in the Governance structure until replaced, at the beginning of

this century, by a more permanent advisory body, the International Monetary and Financial Committee (IMFC).

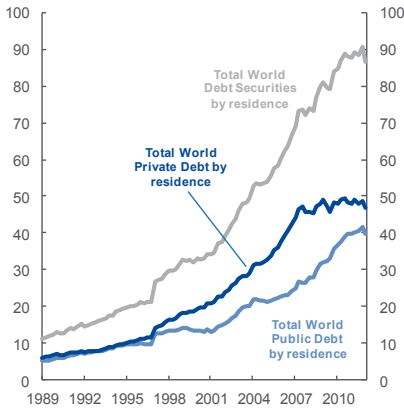
Activation of the Council has been raised unsuccessfully twice since, first in the aftermath of the Asian and Latin American financial crises of the 1990s and most recently in the context of the events of 2008-09.⁴⁷ The latter will be discussed at more length in the sections that follow. Suffice to say, while the US was an early champion of the concept in the late 1970s and early 1980s, it has since been less inclined to lend its support, and both it and emerging market economies have revealed a preference for preserving less formal means of Ministerial engagement in decision making. Moreover, this has been the case despite clear evidence of growing frustration with the effectiveness of both the Executive Board and the IC/IMFC, a concern that appears increasingly intractable.

A GROWING CHORUS

47 Alisa Abrams, "The IMF Council of Governors," in Ruben Lamdany and Leonardo Martinez-Diaz, eds, Op.cit.

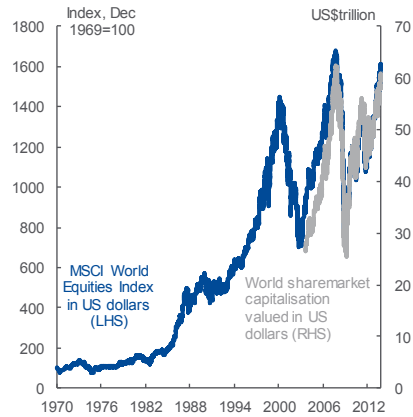
CHART II-2: GROWING CAPITAL MARKETS

Debt Markets⁴⁸



Source: Bank for International Settlements

Equity Markets



Source: Bloomberg

FOR REFORM

As noted earlier, a broadly held critique of the established governance arrangements had begun to crystalize by the late 1990s, early 2000s. It had initially been fueled by disenchantment with the system's (and in particular the Fund's) performance in handling the Asian Financial crisis in 1997-98 and the subsequent challenges that confronted Russia, Brazil and Ar-

gentina. And the prevailing sense of global economic prosperity and stability which took hold for much of the first decade of the new century provided many with the space within which to consider the Fund's continued relevance and adaptability to new challenges.

There were a number of threads to this debate,⁴⁹ but an overarching theme related to the challenge posed by the extraordinary growth

48 Debt Securities include both international and domestic securities.

49 Both Vines and Gilbert, eds *The IMF and its Critics: Reform of Global Financial Architecture* Oxford University Press, (2009)., and Edwin M. Truman, ed. *Reforming the IMF for the 21st Century* Institute of International Economics (Washington DC, April 2006) provide very good coverage of the issues and range of views.

in private capital flows, which thirty years previously had eroded the foundations of the Bretton Woods system of fixed exchange rates and had since grown at unprecedented rates, dominating global financial flows.

Chart II-2 (on page 31) shows the dramatic growth in the size of both international debt and equity markets over recent decades.

Certainly, the growth in international capital flows had swamped the availability of IMF to support members facing balance of payments financing needs, and one commonly agreed implication was that the IMF's relations with its members was fundamentally altered by this development. In particular, it seemed clear that the Fund was no longer a 'universal financial institution', that is a credit union in which all members could conceivably contemplate the potential need to draw on Fund resources, participating as both creditor and debtor at different stages in the revolving-fund nature of the Fund.⁵⁰ Instead, the

membership seemed to divide into three distinct categories. First, advanced economies which were very unlikely to ever need to use Fund resources and were likely to remain permanent creditors of the institution. (Ironically, most lists at the time placed Greece, Portugal and Ireland among this group.) The effectiveness of Fund surveillance in addressing growing concerns about global imbalances was under growing scrutiny. Secondly, the group of emerging market middle income economies, with access to foreign capital markets, but with still fragile domestic policy frameworks and institutions. This group was especially susceptible to periodic capital account crises, which tested the Fund's traditional policy prescriptions and capacities. Finally, the low income country members which made up the bulk of the membership by number, faced continuing long term development challenges, had only limited access to private capital markets and had become long term users of Fund resources.⁵¹

50 However, James M. Boughton, in "Does the World Need a Universal Financial Institution" IMF Working Paper WP/05/116, made a good effort to refute this popular perception.

Many competing visions for the future of the Fund emerged from this debate. At one extreme, the Meltzer Commission⁵² envisaged a trimmed down and very selective IMF, focused on financial crisis prevention, eschewing any development role in low income countries beyond macroeconomic advice, and providing a limited short term Lender of Last Resort (LoLR) function for members that pre-qualify on the basis of a short list of policy pre-conditions. Others were more focused on how best to enhance the Fund's powers and effectiveness, such as the development of reference exchange rates as a framework against which the Fund could promote efforts to minimize unsustainable imbalances.⁵³ In his September, 2005, Per Jacobsson lecture at the IMF/World Bank annual meetings, former Fund MD Michel Camdessus laid out an expansive

and comprehensive agenda for the Fund. This included cementing its role as the globalized financial system LoLR, with significantly enhanced financial and human resources. He also championed increased support for low income countries, more active promotion of the SDR as a source of liquidity, and extending the Fund's legal reach to encompass capital flows. He argued for the Fund to be at the center of a bold initiative modeled on the active attempts at policy coordination in the 1980s. To enhance the Fund's legitimacy, he proposed activation of the Ministerial Council to replace both the IMFC and all Gs, and to mirror a smaller Executive Board with significant changes in composition, in particular the consolidation of European representation into one chair to make room for expanded emerging market representation.

51 The Fund's Independent Evaluation Office Report, *IMF Interactions with Member Countries* (International Monetary Fund, 2009), uses this classification of the membership. Briefly put, its findings were that advanced Country members thought the Fund irrelevant, emerging market members thought the Fund relevant but ineffective, while low Income members' perceptions were strongly colored by their dependence on Fund financing.

52 The International Financial Institution Advisory Commission, appointed by the US Congress in July 1999.

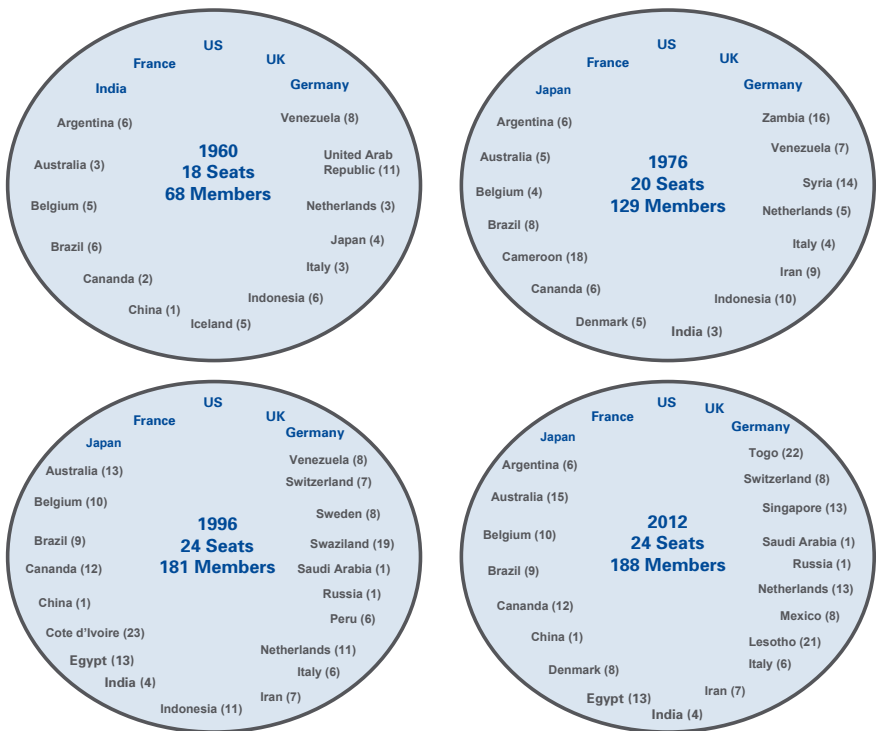
53 John Williamson, "Revamping the International Monetary System," in Edwin M Truman, Op.cit.

While there were divergent views on the Fund's appropriate role, there was a striking commonality of view on the issue of governance reform. Addressing governance shortcomings had increasingly come to be seen as crucial to both the Fund's legitima-

cy and effectiveness, and central to the Fund's identity crisis.⁵⁴

The core issue to be addressed was clearly the misalignment of voting power and representation with emerging economic and political realities, and in particular

CHART II-3: EXECUTIVE BOARD – EVOLUTION OVER TIME⁵⁵



Source: UN Yearbooks (1960 and 1976 end of calendar year), IMF Annual Reports (1996 and 2012 end of IMF financial year)

the increasing relative importance of emerging market economies.

Chart II-3 shows the evolution of Executive Board representation over the history of the Fund.

At the Fund, as others have stressed, the consensus driven approach to decision making in which formal votes are seldom taken means that relationship between voice and voting shares is a complex and subtle one.⁵⁶ As of 2005, 10⁵⁷ of the 24 members

of the Fund's Executive Board, either were, or represented constituencies including, European countries. These Chairs held 44.4 percent of the Fund's voting power, and six executive Directors and eight Alternate Directors were nationals of the EU. Even putting aside the votes of the two non-European Executive Directors, the voting share of the Europeans accounted for 36.6 percent. By way of a reference point, the European Union's share of real world

54 Edwin M Truman, "Implications of Structural Changes for Management of the Global Economy", in Richard Samans, Marc Uzan and Augusto Lopez-Claros, eds. *The international monetary system, the IMF, and the G-20: a great transformation in the making?* World Economic Forum, (Palgrave Macmillan, 2007) p 58

55 Appointed Directors in blue. The five largest members of the Fund in terms of quota automatically get to appoint a Director to the Executive Board; however, up to two of the largest members of the Fund, outside the top five, may be allowed to appoint a Director if its currency is in particularly demand (Article XII, Section 3(c)). A temporary sixth Director was appointed from 1958-1960 (Canada), 1968-1970 (Italy), 1970-1972 (Japan appointed a Director upon becoming one of the five largest members of the Fund, displacing India, who was able to appoint a temporary sixth Director for this period), and from 1978 to 1992 (Saudi Arabia).

All other Directors are elected to represent a group of constituencies (with the number in brackets representing constituency member countries). More information on group constituencies can be found at Annex 1.

The sum of all constituency group members may not be equal to that of total Fund members, as some countries may not have participated in the Regular Election of Executive Directors, or were suspended from the Fund for a period of time.

56 Edwin M Truman, "Rearranging IMF Chairs and Shares: the Sine Qua Non of IMF Reform", in Truman ed Op.cit.

57 Germany, France, UK, Belgium, the Netherlands, Mexico (representing Spain), Italy, Canada (representing Ireland), Norway, and Switzerland. It is hard to know what weight Ireland carries in the Canadian chair, although it has a permanent Alternate Executive Director's position. Spain has a significant share of the voting power of the chair it shares with Mexico, and provides the Executive Director or Alternate four years out of every six.

GDP⁵⁸ at the time was close to 30 percent. The US, which accounted at the time for around 28 percent of world GDP, had 17.08 percent of the Fund's voting power. Asian members held 5 chairs, and a total voting share of a little under 18 percent. China's voting share was less than 3 percent, compared with a share of real global GDP of just under 5 percent — and one that was growing strongly. Similarly, in Latin America, Brazil's voting share was 1.4 percent, compared to GDP share closer to 2 percent. Similar comparisons can be made for most other significant emerging market economies.

Nor was there a defensible relationship between actual Fund quota shares (the main driver of voting shares) and the calculated quota shares produced by the quota formula. As noted earlier, the formula had not been applied in any consistent or systematic way over the history of the Fund. Rather it had provided a starting reference point for what were inevitably politically negotiated

outcomes. So, for example, while China's calculated quota of 4.63 percent was closer to its actual share of world GDP, the combined calculated quota share for European members was closer to 40 percent, significantly higher than their combined share of global GDP. This reflected the weight given to factors other than GDP in the formula, such as openness to international trade. To the extent it produced anomalies, such as a calculated quota share for Luxembourg larger than that for each of Russia, Brazil, or India, and around three times that for Turkey, it seriously undermined the credibility of the quota formula, at least in the eyes of the emerging markets, if not in those of the Europeans.

More fundamentally, putting arcane issues of quota formulae and percentage shares to one side, it was a matter of ensuring that the real and prospective weight of emerging market economies in global economic activity, and world affairs more generally, was seen to be reflected in the distribution

58 GDP in constant 2005 US dollars. Dollar figures for GDP are converted from domestic currencies using 2000 official exchange rates. For more information, see The World Bank, *World Development Indicators*, (2013).

of influence at the Fund. This was essential if the Fund was to have legitimacy with the citizenship, and hence the governments, of these members. It was obvious to most, for example, that a first step to rebuilding credibility in Asia following the reputational damage suffered by the Fund through 1997-98, had to be an acknowledgement that a region that was clearly emerging as the primary driver of world output growth for the next few decades⁵⁹ had to have a bigger say on the Board of the IMF, and in the international community more generally. And for the emerging markets to increase their voice, the relative weight of European voices around the table had to make way both in terms of voting share and chairs.

The disproportionate European presence on the Board, a legacy of history and inertia, was also reflected in the unwritten agreement between the Europeans and the US that had held sway since Bretton Woods, that the Managing Director of the Fund would always

be a European, while the US would provide the President of the World Bank — an agreement guaranteed by the combined voting share of the two.

The composition of the IMFC (and its predecessor, the Interim Committee) mirrored that of the Executive Board and therefore shared the same shortcomings in terms of representation and legitimacy. But concerns about the effectiveness of the IMFC also reflected other factors, which might be most easily summed up as a lack of ownership of its deliberations by its members. As an advisory committee, it took no formal decisions, although its voice — i.e. that of the political masters of the Fund's Executive Directors — naturally carried significant weight with the Executive Board. Nonetheless, its agenda was heavily influenced by Fund Management, working closely with the IMFC Chair, who at that time and since 1999, had been the UK Chancellor, Gordon Brown. Concerns about undue

59 See, for example, The Australian Government's White Paper, *Australia in the Asian Century*, (2012), Chart 2.2, p51

G7 influence therefore mingled with the perception of pre-cooked meetings, orchestrated by Management. Participants often stuck to prepared scripts with limited genuine exchange. A Deputies' process, involving a mix of senior officials from capitals and Fund Executive Directors, did not seem to add much value as it too involved similar dynamics, and the meetings were generally held too close to the IMFC meetings to be able to influence the agenda.

The legitimacy of the 'self-appointed' G7 steering group for the system was also coming under scrutiny. Its effectiveness in handling global macroeconomic challenges, such as the increasingly vexed question of global economic imbalances without the participation of key contributors to those imbalances, was being questioned. In 1999, the G7 had itself announced the creation of

the G20 Finance Ministers' and Central Bank Governors' process⁶⁰ '...to widen the ongoing dialogue on the international financial system to a broader range of countries.'⁶¹ The Fund, the World Bank and the ECB were also to participate. Making more effective use of the IMFC was considered but rejected, in large part because of the concerns about its membership, pro-forma procedures and capture by Fund management referred to above.⁶² This was an important development, with potential to significantly improve the legitimacy of international economic governance by providing a more effective voice for systemically important emerging markets together with broad regional representation. Nonetheless, this grouping remained heavily influenced by G7/8 agendas and positions, and was necessarily limited by the fact that it did not

60 Membership consisted of the G8, plus Argentina, Australia, China, Brazil, Korea, Mexico, India, Indonesia, Saudi Arabia, South Africa, Turkey and the President of the European Union (if not currently among the G8). This membership reflected a number of considerations, among them systemic importance and geographical representation, but also G7 member preferences as to the composition of the expanded membership with which they felt they could work effectively.

61 June 1999 Report of the G7 Finance Ministers to their heads of State on "Strengthening the International Financial Architecture"

62 Leonardo Martinez-Diaz, "The G20 after Eight Years: How effective a Vehicle for Developing Country Influence" Global Economy and Development Working Paper no. 12, (The Brookings Institute, 2007)

meet at the level of Leaders. By the middle of the decade, a consensus remained elusive on whether the G20 provided the right model for the future. There was no shortage of suggestions for alternative models, such as a G12-15 (involving the G8 plus the major emerging markets, loosely built around the BRICS — Brazil, Russia, India, China and South Africa — and possibly expanded to also include Indonesia and Mexico), or a grouping which would involve the European representation being consolidated in a single chair alongside the other members of the G20.⁶³ And the question of the relationship between such a grouping and the G7/8 was likely to remain moot so long as any new forum did not meet at Leaders' level.

At the same time, improving political stability in much of the developing world, especially Africa, and associated strengthening economic performance, underscored the determination of the smaller states which made up the

vast majority of the membership of the international community not to be disenfranchised by these developments.

Finally, a light had also been cast on the internal governance of the IMF, and revealed a number of concerns. The Fund's Independent Evaluation Office (IEO) report on Governance⁶⁴ provides a comprehensive overview of the issues involved. The IMFC's shortcomings as a means of political engagement were matched by a lack of clarity about the respective role of the Board and Management. A residential Board of middle-level to senior officials involved a natural tendency to micro-management and excessive preoccupation with process — especially the time spent on routine Article IV surveillance reports where the value added by the Board discussion was at best debatable — distracting the focus from more strategic, high level considerations.

While no doubt frustrated by the tendency to micro-management,

63 See, for example, C. Fred Bergsten, "A New Steering Committee for the World Economy?," in Truman, Op.cit.

64 Independent Evaluation Office, *Governance of the IMF: An Evaluation*, (IMF, 2008)

there were equally incentives for Management to be a willing accomplice in arrangements that kept the Board busy on issues of form rather than substance, while preserving its primary control over shaping the work program. Selection practices for Executive Directors which produced a tendency to excessive turnover, alongside a handful of very long term incumbents with excessive ownership of existing practices, were also identified as unhelpful. Subsequent IEO studies suggested that this environment had nurtured a number of internal institutional weaknesses — a culture of silos and group think, lack of diversity, and a degree of ambiguity about how the Fund should best engage its members (as independent supervisor, source of technical guidance, trusted policy adviser, or some considered combination of all of these), which was reflected in lack of clarity about the skills and capacities the Fund valued among its staff.⁶⁵

On the eve of the crisis, there-

fore, there was a broadly, if not unanimously, shared critique of international financial governance. Moreover, elements of a possible response were beginning to emerge.

The G8 had begun experimenting with expanded attendance on selected issues at its meetings. Starting in 2005, the Leaders of Brazil, China, India, Mexico, and South Africa had been invited to attend G8 discussions for certain sessions, although this experiment only served to underscore the unsustainability of such a partial solution.⁶⁶

In 2006, agreement had been reached on a two stage process designed to achieve a significant realignment of quota and voting shares. Stage one involved immediate ad hoc quota increases for China, Korea, Mexico and Turkey, totaling 1.8 percent of the Fund's existing quotas. The second stage, subsequently agreed in 2008, involved agreement on a new, significantly simplified quota

65 See IEO reports on The Fund's Interactions with its Members, and the Fund's Pre-Crisis Performance.

66 Gordon S. Smith, *Op.cit.*

formula, and further ad hoc quota increases totaling 9.55 percent of quotas targeted to those members, especially emerging market and developing country members, considered most underrepresented in terms of the new formula. As part of the agreement, advanced economy members eligible for an ad hoc increase — Germany, Ireland, Italy, Japan, Luxembourg, and the United States — also agreed to forgo their additional quotas in order to fund further targeted increases for selected emerging market economies, in particular the four countries which had been the focus of the initial 2006 ad hoc increases. And basic votes for all members were tripled, with an agreement that their restored weight in overall votes should be preserved. The result was an increase in quota share for fifty-four members, totaling 4.9 percent of quotas, and an increase in voting share, of the order of 5.4 percent, for 135 Fund members, mainly emerging market and developing countries.⁶⁷

The new IMF MD, Dominique Strauss Kahn, a year into his term in late 2008, was actively looking to build on the IEO report and recommendations regarding Governance, notwithstanding the opposition of large sections of the Executive Board. Faced with this lack of Board enthusiasm, he asked an outside eminent persons' group, under the chairmanship of the respected South African Finance Minister, Trevor Manuel, to provide him with independent advice on options to reform Fund governance. The report, delivered in March 2009, strongly endorsed the IEO's findings and placed activation of the Council of Ministers back on the agenda.⁶⁸

Well intentioned commentators speculated about the prospect for a 'grand bargain' that would produce a package of reforms at both the institutional and steering group level that would produce '...an international system that is more able to meet global challenges, through more democratic, inclusive, and effective global

67 The 2008 package came into effect on March 3, 2011, once the necessary national legislative processes had been completed.

68 *Final Report of the Committee on IMF Governance Reform*, (IMF, March 2009)

governance.⁶⁹

Initiatives had also been taken to address concerns about the Fund's effectiveness in its core business of surveillance of members' policies. In 2005, the Fund indicated its intention to convene multilateral consultations involving five key systemically important economies — the US, China, the Euro Zone, Japan, and Saudi Arabia — central to the issue of global imbalances. These consultations took place at senior officials' level between late 2006 and through 2007. Also, in response to US concerns regarding the Fund having dropped the ball on exchange rate surveillance,⁷⁰ Management pushed through agreement in 2007 on a new Board surveillance decision, which sought to give greater emphasis to judgments about appropriate exchange rate settings. In the event, both these initiatives fell well short of their proponents' hopes for them.⁷¹

The challenges involved in such efforts will be discussed in more detail below. Suffice to say that, while ambitions of governance reform had been raised on the eve of a crisis which would place significantly enhanced demands on the capacity for collective international action, the underlying challenges of sustaining such action remained no less real.

69 Colin I. Bradford Jr. & Johannes F Linn, Op.Cit, page 10.

70 Timothy D. Adams, Under-Secretary for International Affairs, *The IMF: Back to Basics*, Speech to the Peterson Institute for International Economics, (September, 2005)

71 Paul Blustein, *A Flop and a Debacle: Inside the IMF's Global Rebalancing Acts*, CIGI Papers No 4, (Center For International Governance Innovation, June 2012)

Section 2: International Economic Governance on the Eve of
the Financial Crisis — a System Under Challenge



Section III

2008-09 — A High Water Mark for International Coordination?

The period from late 2008 through 2009 was one of intense activity and ambition in international cooperation and coordination, as the key systemically important players recognized the crucial importance of a collective response to what, it was becoming increasingly clear, was the single most serious crisis to threaten the global economy in the post war period. It was a period which saw the establishment of the G20 Leaders' process, and its endorsement as the 'premier forum' for international economic cooperation,⁷² alongside the revitalization of the IMF as the core international institution on financial issues. Moreover, govern-

ments moved remarkably quickly to signal a shared commitment to enhanced cooperation, agree the details of an ambitious and comprehensive agenda for their collective response, and deliver on threshold issues crucial to placing a floor under market confidence, hitherto in free fall — in particular a dramatic boost to the resources available to assist countries facing difficulties. By the time of the Pittsburgh Summit in September 2009, Leaders were increasingly focusing on the challenges of locking in recovery, in the context of a framework for 'strong, sustainable and balanced global growth'.⁷³

In the section that follows, I will

72 The G20 Leaders' Statement, The Pittsburgh Summit, September 24-25, paragraph 19

73 Ibid, paragraph 13

explore some of the challenges that have subsequently become apparent in delivering on a number of the elements of the G20 agenda. But this should not detract from the importance of the achievements during this period. They demonstrate the capacity of governments to commit to collective action when confronted by a sufficiently strong imperative. And they are owed a significant part of the credit for avoiding a repetition of the economic and human catastrophe triggered by

the financial market crisis of 1931. When the then IMF Managing Director, Dominique Strauss-Kahn, informed the members of the IMFC in October 2008 that developments 'have pushed the global financial system to the brink of systemic meltdown,'⁷⁴ he did not do so lightly.

Box III - 1 sets out a time line summarizing the unfolding crisis and key developments in the evolution of a collective response.

The crisis that unfolded through

74 Statement by the IMF Managing Director, Dominique Strauss-Kahn to the International Monetary and Financial Committee on the Global Economy and Financial Markets, October 11, 2008

BOX III-1: KEY DEVELOPMENTS OF THE FINANCIAL CRISIS

Date	Event	Government/Agency Response
2006	July: US house prices peak.	Aug 8: US Federal Reserve maintains interest rates for first time after two years of increases (from a low of 1 percent in 2004 to 5.25 percent).
2007	Feb 27: Freddie Mac announces that it will no longer buy subprime mortgages and mortgage related securities.	

Date	Event	Government/Agency Response
2007	Jun 1: Moody's downgrades 100 subprime-backed bonds.	Jun 6-8: G8 Summit held in Heiligendamm, Germany, which presents a reasonably optimistic view of the economic outlook, and is noted as the first formal involvement with selected emerging economies (Brazil, China, India, Mexico and South Africa).
	Jul 11: Standard and Poor's places 612 securities back by subprime residential mortgages on a credit watch.	
Global financial markets show signs of stress; problems in the mortgage market spill over into other sectors, leading to diminished liquidity in interbank markets.		
	Aug 9: BNP Paribas, France's largest bank, halts redemptions on three investment funds.	
	Aug: The failure of German banks, IKB Deutsche Industriebank and the Landesbank Girozentrale Sachsen, due to large exposures to US debt foreshadow both growing risks to the banking sector and cross border vulnerabilities.	Aug 17: US Federal Reserve reduces discount (primary) rate for the first time, which will be aggressively lowered over the next sixteen months, to a low of 0.5 percent in December 2008.

Date	Event	Government/Agency Response
		<p>Sep 18: US Federal Reserve reduces federal funds rate for the first time, which will be aggressively lowered over the next fifteen months, to a range of 0-0.25 percent.</p>
		<p>Dec 12: The FOMC authorizes swap lines with the ECB and Swiss National Bank, of US\$20 billion and US\$4 billion, respectively. The amounts and number of swap line agreements expand rapidly over the next year.</p>

<p>2008</p>	<p>Feb 14: UBS announces significant losses associated with exposures to US mortgages.</p>	<p>Feb 13: Economic Stimulus Act of 2008 signed into law, injecting approximately 1 percent of GDP largely in the form of tax rebates.</p>
<p>Feb 17: The UK's fifth largest mortgage lender, Northern Rock, taken into government ownership after an extended period of liquidity support from the Bank of England.</p>		
<p>Mar 14: US Federal Reserve forced to broker a deal for JPMorgan Chase to take over the liquidity strapped Bear Stearns, the US's fifth largest investment bank.</p>		

Date	Event	Government/Agency Response
2008		<p>Apr 7: The FSF delivers its report on the causes and weaknesses of the recent financial turmoil, commissioned by the G7 Finance Ministers and Central Bank Governors in Washington in Oct 2007, laying out a comprehensive set of sixty-seven recommendations, covering financial regulatory policy and institutional arrangements. This report is later endorsed by the G7.</p>
<p>Sep 7: Fannie Mae and Freddie Mac placed in government conservatorship.</p>		
	<p>Sep 15: Lehman Brothers files for bankruptcy.</p>	<p>Sep 16: US Government provides emergency loan to AIG.</p>
<p>In Europe, governments in the UK, Germany, Denmark, the Netherlands, Latvia, Ireland and Iceland are forced to step in to varying degrees over the days and months following Lehman's collapse, to support systematically important financial institutions.</p>		
		<p><i>Sep 20: The US Administration seeks approval to use a significantly larger quantum of public funds to remove toxic assets from the banks' balance sheets.</i></p>

Date	Event	Government/Agency Response
2008		<p>Sep 22: G7/8 conference call meeting, under the chairmanship of Canada, to discuss global financial markets and provide support for “the extraordinary actions” taken by the US, and others, to address liquidity pressures and stabilize financial markets.</p>
<p>Oct 8: The Bank of Canada, the Bank of England, the ECB, the US Federal Reserve, Sveriges Riksbank, and the Swiss National Bank, jointly announce collective action to lower interest rates.</p>		
		<p>Oct 9: IMF management invoke the Emergency Financing Mechanism (EFM) which allows for significantly truncated negotiation and approval times for Fund programs. Six of seven new programs approved by the end of 2008 have these emergency arrangements applied.</p>
<p>Oct 10: The G7 Finance Ministers and Central Bank Governors release a Plan of Action to “take decisive action and use all available tools” to protect systematically important institutions, “take all necessary steps” to unfreeze credit markets and provide liquidity, ensure adequate capital for banks and financial institutions and robust insurance and guarantee programs, and to “take action, where appropriate” to reinvigorate secondary markets for asset backed securities.</p>		

Date	Event	Government/Agency Response
	<p>Oct 11: A meeting of G20 Finance Ministers and Central Banks Governors was convened at the 2008 IMF/World Bank Annual Meetings. President Bush surprises the meeting by joining it and asking to address the participants. Within days of this meeting, the US takes the initiative to convene the first G20 Leaders' Summit.</p>	
	<p>Nov 14-15: The first G20 Leaders' Summit, held in Washington DC. The Summit issues a Declaration, which details a forty-seven point Action Plan, a comprehensive work plan which adds significant detail to the commitments made by the G7 regarding financial sector policies. The Declaration also establishes a more tangible prioritization of future work, and arrangements to monitor the delivery of its commitments. In addition, it's made clear that the adequacy of Fund resources, and of the Fund's lending tool kit, would have to be addressed, and that the Bretton Woods institutions would need to be comprehensively reformed.</p>	
		<p>Nov 19: The first Fund program approved for an advanced economy, Iceland, since the 1970s. This program was also approved under the EFM.</p>
<p>By the end of 2008, the FOMC has put in place a total of US\$750 billion in bilateral swap arrangements.</p>		

Date	Event	Government/Agency Response
2009		<p>Apr 2: G20 London Leaders' Summit, which led to an agreement on a package of US\$1.1 trillion in additional financial resources to tackle the crisis, including:</p> <ul style="list-style-type: none"> • a trebling of Fund resources to US\$750 billion; • a new SDR allocation of US\$250 billion; • a US\$100 billion funding mechanism to increase the Fund's concessional resources and support for new MDB lending to low income countries; and • US\$250 billion over two years to support trade finance.
<p>(G20 London Leaders' Summit continued) Leaders' also agree to establish a joint Early Warning Exercise with the FSF that would meet the Leaders' demand for strengthened capacity to forewarn of future crises.</p> <p>Other London outcomes include: agreement on a new body, the Financial Stability Board (FSB); a concrete agenda to follow through on reform of the IFIs, focusing on the reform of their “..mandates, scope and governance”, which includes accelerated efforts to implement the Fund's quota and voice reforms and the parallel agenda at the World Bank, and “..greater involvement of the Fund's Governors in providing strategic direction to the IMF and increasing its accountability”.</p>		

Date	Event	Government/Agency Response
	Sep 24-25: G20 Pittsburgh Leaders' Summit, where Leaders' shift the focus to the recovery, under the rubric of 'a framework for strong sustainable and balanced growth'. Agreement is also reached on quota and voice reforms, with "...a shift in International Monetary Fund quota share to dynamic emerging markets and developing countries of at least 5% from over represented countries", while "...protecting the voting share of the poorest".	At this point, G20 Leaders' felt able to designate the G20 the premier forum for international economic cooperation.

THE ORIGINS OF THE CRISIS

2007 and 2008 was distinguished not just by the breadth and potential depth of its impact but also because its origins clearly related to policy failures in the world's largest economy. It is worth recapping on developments as the crisis gathered momentum.

The first half of the decade had been characterized by historically strong global growth — approaching 5½ percent⁷⁵ by 2006. Inflationary pressures had remained largely contained. Rather, the focus of concern, as noted in

the previous section, were the persistence of large global imbalances, primarily the financing of the US's growing current account, equal to 6½ percent of GDP in 2006,⁷⁶ by surpluses in China and the oil exporting countries. Opinion differed on whether these imbalances should be seen as the relatively benign result of a global savings glut in search of productive investment opportunities or the potentially destabilizing product of lax macroeconomic policy settings and household dissaving in the US alongside a deliberate

75 IMF, *World Economic Outlook*, April 2007, Statistical Appendix, Table 1, Page 211

76 Ibid, Table 26, Statistical Appendix, Page 249

policy of reserves build up and exchange rate manipulation in the surplus economies.⁷⁷ However one characterized the underlying causes, it is notable that the US accounted for close to 64 percent of total global capital inflows as of March 2007.⁷⁸

There is no doubt that the substantial impact of the global imbalances on the size and direction of global capital flows helped establish an environment conducive to excessive risk taking in the advanced economy financial markets. Real interest rates in key financial markets, had been close to zero or negative for much of the period through to 2005, driven initially by the monetary policy response to the US recession in 2001. Significant investment flows into US Treasuries and agency debt, in particular that issued by US Government Sponsored Enterprises (GSEs) such as Fannie Mae and Freddie Mac, worked to dampen yields in global fixed interest markets. Risk premia,

as reflected in market spreads and the cost of insuring against default, has been consistently low and generally on a downward trend.⁷⁹

Moreover, risk premia increasingly only told part of the story. In a speech in January 2009, ECB President Jean-Claude Trichet argued that, even more important than underpricing each unit of risk had been the increasing tendency of markets to fail to identify the quantity of risk involved in investments.⁸⁰ Financial innovation, in particular, securitization and the development of new, complex financial instruments meant that risk was not adequately understood or captured in the investment decisions being made. Securitization, the process by which banks package portfolios of cash flow producing financial instruments into securities that can be sold to third parties, grew dramatically through the late 1990s and first half of the last decade. The value of privately

77 See, e.g. Joseph P Joyce, *The IMF and the Global Financial Crisis: Phoenix Rising?*, (Cambridge University Press, 2013) pp154-161

78 IMF, *Global Financial Stability Report*, April 2007, Statistical Appendix, Figure 1, page 141

79 Ibid, pages 37-46

80 Jean-Claude Trichet, *Underpricing of Risks in the Financial Markets*, speech delivered to the Coface Country Risk Conference, January 2009

issued securitized assets grew from just under \$US1.5 trillion in 2000 to close to \$US5 trillion by 2006, with the bulk of the growth being driven by mortgage backed securities. US issuance was the largest contributor to this growth, totaling just under \$US 3.5 trillion in 2006, of which mortgage backed securities accounted for a little over a \$US1 trillion, approximately ten times the level in 2000.⁸¹

The rapid growth in securitization was thus inextricably linked to the evolving housing market bubbles in the US and elsewhere. From the issuers' perspective it offered the attraction that these assets, and the risk they represented, could be held off-balance sheet, in special purpose vehicles, thereby avoiding the cost of holding the capital that would be required against on-balance sheet assets. The mistaken faith that the issuer would be insulated from the embodied risk, further hidden by the complexity of the financial engineering, naturally in turn reduced incentives

to clearly understand the risks involved. In practice, as the system imploded, banks found it difficult to avoid taking on the risks borne by their off-balance sheet vehicles, including because of the reputational links involved.

In this context, the direct and primary cause of the financial meltdown that started in 2007 and gathered pace through 2008 was the failure of financial regulation — and regulators — to ensure the prudent management and control of these risks.⁸²

Tighter monetary policy, which saw the US Federal funds rate increase sharply from a low of 1 percent in 2004 to 5 ¼ percent in 2007, and a weakening trend in US house prices from around 2005, combined to reveal these latent risks through the course of 2007, in the first instance in the subprime mortgage market. This segment of the market, while relatively small, had nonetheless grown rapidly from less than ten percent of all US mortgages in

81 IMF, *Global Financial Stability Report*, September 2009, page 84

the mid-1990s, to over a fifth a decade later. Securitization and clever financial engineering had offered the promise of home ownership for low income borrowers previously denied this, but unfortunately at the cost of an erosion of lending standards and ultimately with disastrous consequences. Moreover, the practice of re-packaging these mortgages in securities that combined, in a very opaque way, a range of default probabilities meant that

it became increasingly hard for holders of these assets to assess the embodied risks.

2007-08

Mounting sub-prime mortgage losses through the first half of 2007 progressively exposed broader systemic vulnerabilities, associated with extensive recourse to leverage and significant maturity mismatches.⁸³ That is, institutions had relied on excessive short term funding, on a rolling basis,

82 It has been argued (for example see Manuela Moschella, *Governing Risk: The IMF and Global Financial Crises*, Palgrave MacMillan, 2010) that, while the fallout from the Asian Financial crisis a decade earlier had undermined the credibility of the Fund, it had not significantly weakened faith in the virtues of liberalized capital markets. Rather, it had encouraged some to press for market led liberalization as an alternative to orderly liberalization led by public sector bodies such as the IMF. This paradigm, it is argued, underpinned the shift towards light touch regulation, with an emphasis on self-regulation and transparency, as reflected for example in the revised banking regulation standards agreed by the Basel Committee on Banking Supervision in 2004 (the Basel II accord).

I am less critical of the regulatory rules per se. While one could mount a case that there were elements of the existing regulatory structure which could be improved (and subsequent G20 agreements have sought to address these), one should not lose sight of the fact that not all advanced economy jurisdictions which had signed up to essentially the same set of rules experienced home grown disruption to their domestic banking systems. Jurisdictions such as Australia and Canada stand out in this regard. In both cases, a key factor in the resilience of their banking sectors was the existence of pro-active prudential regulators with broad powers and a clear commitment to do their job – that is to ensure that private institutions actively and aggressively contained risk and eschewed more extreme and ‘innovative’ business models. To my mind, the dominant factor underpinning the failure of regulation leading to the crisis was the failure of the regulators. Institutional arrangements in the US, which involve multiple overlapping prudential regulators for ostensibly different ‘sectors’ of the financial industry, albeit providing essentially similar products and services, and each often obliged to compete for regulated institutions to choose them as their preferred regulator, clearly were not conducive to a culture of uncompromising, pro-active regulation!

to finance long term assets. By August, problems in the mortgage market had begun to spill over into other sectors, when issuers of asset backed commercial paper indicated problems rolling over their interbank money market debts, and BNP Paribas, France's largest bank, halted redemptions on three of its investment funds, because of difficulties in valuing their assets. The failure of two relatively small publicly owned German banks, IKB Deutsche Industriebank and the Landesbank Girozentrale Sachsen,⁸⁴ both of which had large exposures to US debt, foreshadowed both growing risks to the banking sector and cross border vulnerabilities. In February 2008, the Swiss based giant, UBS, announced significant losses associated with exposures to US mortgages.

Through the course of late 2007, early 2008, concerns about liquidity were rapidly replaced by concerns about the solvency of

significant institutions. The UK's fifth largest mortgage lender, Northern Rock, was taken into government ownership in February 2008, after an extended period of liquidity support from the Bank of England. In March 2008, the Federal Reserve was forced to broker a deal for JPMorgan Chase to take over the liquidity strapped Bear Stearns, the US's fifth largest investment bank, involving \$US30 billion in secured Federal Reserve lending to assist in buying the most toxic of Bear Stearns assets.⁸⁵ (The Fed could not assist Bear Stearns Directly, because, unlike JP Morgan, it was not a bank with access to central bank lending.) In July, concerns surfaced regarding the health of Freddie Mac and Fannie Mae. These two agencies had long been the corner stone of 'mainstream' securitized lending for the US housing market and increasingly were expected to be the mainstay of future housing activity. The US Treasury announced a range of

83 This discussion draws heavily on the timelines presented in the Bank Of International Settlements, *Annual Report, 2009*, Chapter II, and prepared by the Federal Reserve Bank of St Louis, available at the web address, <http://timeline.stlouisfed.org>

84 Harold James, Op.cit. page 100

85 Several commentators at the time saw the Bear Stearns bail out as the death knell for free market capitalism and deregulation. E.G. Martin Wolf, "The Rescue of Bear Stearns Marks Liberalization's Limit" *Financial Times*, March 25, 2008

support measures, including a temporary increase in credit lines and authorization to purchase GSE equity, but by September, both Freddie and Fannie were in government conservatorship.

However, it is the bankruptcy filing by Lehman Brothers on September 15, which is widely seen as the trigger for a generalized crisis of confidence reaching far beyond the US. While the US Administration's decision not to intervene may have been intended as a signal that market disciplines would be allowed to prevail, the revival of such policy purity was short lived. The US Treasury was quickly forced to step in to support the insurance company American International Group (AIG), a core player in the credit default swap (CDS) market which provided insurance against losses on a wide range of securities, and to support the money market mutual fund

sector which faced the threat of a run following sharp falls in the value of shares (in the case of the Reserve management Company, falling through the unprecedented \$1 mark), and which had become central to European bank funding following the break down in the interbank market. In Europe, governments in the UK, Germany, Denmark, the Netherlands, Latvia, Ireland and Iceland were forced to step in to varying degrees over the days and months following Lehman's collapse, to support systemically important financial institutions.

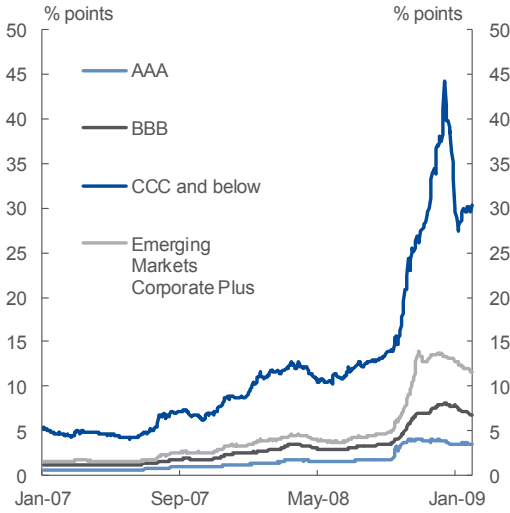
Chart III-1 demonstrates the spectacular rise in financial market risk premiums through this period, as markets rapidly imploded.

Rapidly spreading financial dislocation inevitably was reflected in the real economy. Chart III -2 tracks the evolution of the Fund's

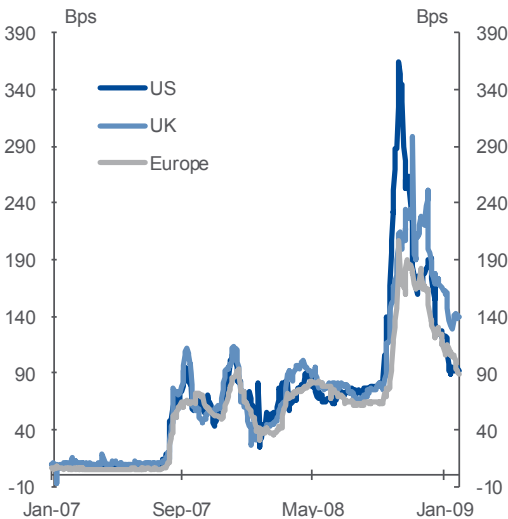
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- 86 Risk Premium on corporate bonds measures the yield on corporate bonds and the 10 year U.S. Treasury bond yield.
- 87 The spread is the three month Libor rate: to OIS for the United States; EONIA for Europe; and SONIA for the UK. The LIBOR-OIS spread is a measure of distress in money markets, as it reflects the willingness of banks to lend to each other, and what banks believe to be the risk of default associated with lending to other banks.

CHART III-1: FINANCIAL MARKET TURMOIL AND INCREASING PREMIUMS

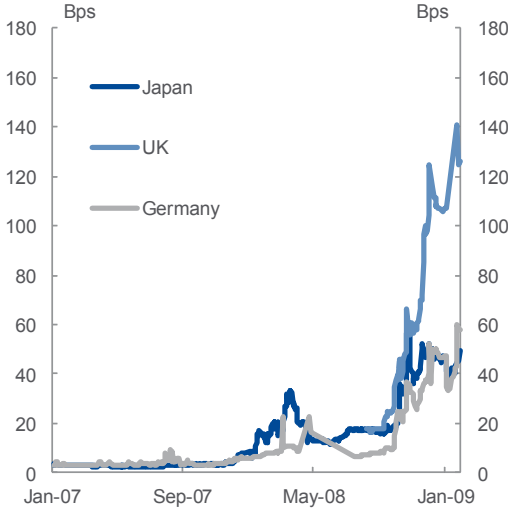
Risk premium on US and Emerging Market Corporate Bonds⁸⁶



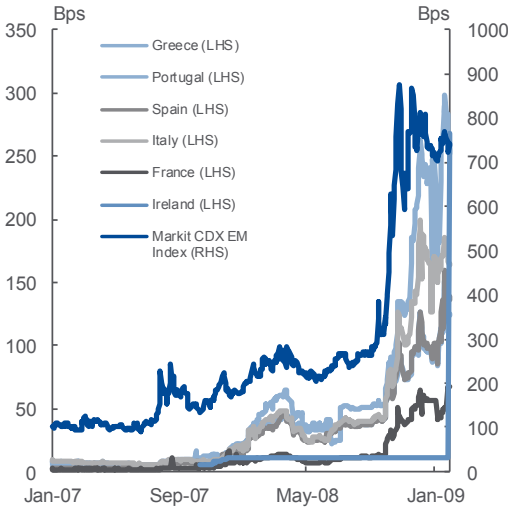
Money Market Spreads⁸⁷



Credit Default Swap Premia for sovereigns



Credit Default Swap Premia for sovereigns⁹⁸

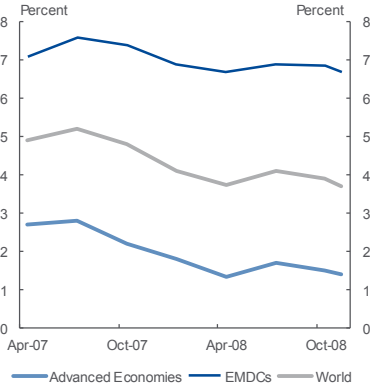


Sources: Bloomberg; St Louis Federal Reserve

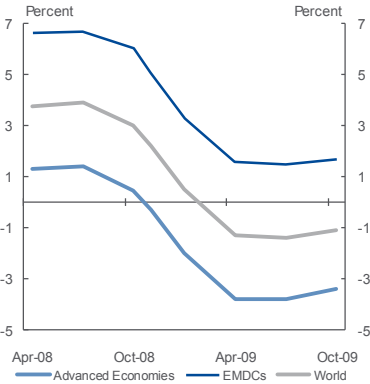
Note: CDS spreads are five-year tenors, in basis points.

CHART III-2: IMF WORLD ECONOMIC OUTLOOK GROWTH FORECAST EVOLUTION 2008 – 2009

2008



2009



Source: IMF World Economic Outlook Reports

88 The market CDX EM Index is composed of 14 sovereign issues from: Latin America; Eastern Europe, the Middle East and Africa: and Asia.

growth forecasts for 2008 and 2009 through the period April 2007-October 2009.

By April 2008, the IMF was beginning to scale back its forecasts for global growth for that year, down over a percentage point to a forecast 3.7 percent. It forecast similar growth for 2009.⁸⁹ A year later, on the back of a weaker outcome for 2008, it had dramatically adjusted its outlook for 2009, and was then predicting that global output would actually decline by around 1.3 percent.⁹⁰ Previous recessions in the advanced economies had nonetheless been associated with positive, if low, rates of global growth. The global reach and depth of the crisis was unprecedented in the post war era.

The deteriorating outlook for the advanced economies had driven much of this increasing pessimism. By April 2009, as the impact of plummeting confidence and lack of credit took hold, the Fund was forecasting declines of close to 3 percent and over 4 percent, respec-

tively for the US and the Euro Area, where only a year before it had been looking to positive if modest rates of growth for both.

The turnaround over this period in the Fund's projections for the emerging markets was, however, even more dramatic. Through 2007 and the first half of 2008, although no doubt carefully monitoring developments in the US and other advanced economies, emerging markets had taken comfort from their significantly improved policy frameworks and reserve buffers. Talk of 'decoupling' from the advanced economies may have encouraged a degree of complacency. Certainly, the tone of emerging market officials' commentary on the unfolding events in the US and Europe at international forums early in this period reflected a mix of cautious concern, criticism of advanced economy policy failures, and a degree of quiet satisfaction that they could, for once, claim the high moral ground on developments that, they hoped, would not

89 International Monetary Fund, *World Economic Outlook: Housing and the Business Cycle*, (IMF, April 2008) Table 1.1

90 International Monetary Fund, *World Economic Outlook: Crisis and Recovery*, (IMF, April, 2009), Table 1.1

prove to be their problem. Nevertheless, between April 2008 and April 2009, the Fund scaled back its outlook for 2009 output growth by the order of 3-3.5 percentage points for both China and India, by close to 5 percentage points for Brazil, by 10 percentage points for Newly Industrializing Asia (consisting of Korea, Singapore, Hong Kong and Taiwan) and by 12 percentage points for Russia.

The two largest emerging Asian economies had been able to offset contagion effects to some degree by stimulatory domestic policy settings, and had been relatively protected by the smaller share of trade in their overall economic activity, although the substantially below trend growth rates would place significant burdens on both countries' efforts to manage domestic aspirations. However, those emerging markets with dominant trade sectors were especially hard hit by both the collapse in advanced country demand — and falling commodity prices — and the drying up of trade

finance. Significant contractions in economic activity were now anticipated for 2009 for Russia, Brazil, and the newly industrializing Asian economies. Central and Eastern European emerging markets were also confronted by the risks associated with their close financial links to European banks, alongside the exposure of emerging markets more generally to the reversal of capital inflows and associated corporate and banking sector vulnerabilities.⁹¹

SHAPING A COLLECTIVE RESPONSE ON THE RUN

The US, at the core of the financial crisis, was understandably preoccupied with its domestic efforts to manage and contain the disruption in financial markets and limit the spillover to the real economy. Over a fifteen month period commencing in September 2007, the Federal Reserve aggressively lowered the federal funds rate by 5 percentage points, to a range of 0-0.25 percent, pressing against the zero interest rate lower bound

91 International Monetary Fund, *Global Financial Stability Report: Responding to the Financial Crisis and Measuring Systemic Risks*, (IMF, April 2009), pp 10-23

where it has remained over the subsequent four years. The limits of conventional monetary policy tools also required the use of less conventional approaches, as the Federal Reserve sought to influence market expectations, and to use the asset side of its balance sheet — sometimes in partnership with the Treasury — to provide liquidity (either through financial institutions or directly to borrowers and investors) and directly influence key credit markets by the targeted purchase of longer dated securities.⁹² Other central banks, in Europe and elsewhere, were also being pressed by events to stretch conventional tools and demonstrate flexibility.⁹³ Early recourse to fiscal tools was more cautious. The Economic Stimulus Act of 2008, signed into law in February of that year, had injected approximately 1 percent of GDP largely in the form of tax rebates, the direct stimulatory effect of which was questionable. However, by the September

2008, the Administration was seeking approval to use a significantly larger quantum of public funds to remove toxic assets from the banks' balance sheets.

Senior Fund staff members have intimated that the US was notably less engaged on playing its traditional leadership role in shaping an international response to the crisis through the first half of 2008. Nevertheless, it was increasingly conscious of the imperative of engaging other systemically important governments in a structured way. And, as emphasized in the preceding section, by the eve of the crisis, a clear consensus had emerged, including among G7 countries, that the G7 was no longer an effective forum for such engagement. The truly global nature of the crisis highlighted above meant that it would be untenable to deny the very real stake of the emerging market economies in shaping a response.

92 Ben S. Bernanke, *The Crisis and the Policy Response*, Stamp Lecture, London School of Economics, January 13, 2009.

93 Notably the Bank of England appeared least open to this challenge. It has been suggested to me by a regulator colleague that the Northern Rock experience was made worse by the fact that the key institutions shaping UK financial sector policy involved a 'flexible' prudential regulator and an 'inflexible' central bank, arguably the opposite of what is needed to ensure stability and manage crises.

Moreover, this was both a matter of principle — and hence the legitimacy of any collective action — and of practical necessity.

While the immediate focus was on restoring stability to the advanced economy financial markets at the core of the crisis, even this would require the cooperation of those emerging markets that held significant volumes of advanced economy sovereign and agency debt. As of end June, 2008, the US Treasury estimated that mainland China (i.e. excluding Hong Kong and Macau) held some \$US 369 billion in GSE debt, in addition to holdings of long dated Treasuries of \$US 568 billion.⁹⁴

Efforts to address longer term challenges involving the scope for coordinated macroeconomic policy responses, and efforts to strengthen the international system's resilience to future potential crisis, clearly could not be effective if the jurisdictions accounting for some 26 percent⁹⁵ of global GDP and a significant share of global savings and investment flows were not

given a voice.

The established G20 network of financial officials provided a natural and readymade vehicle for the US keen to keep key partners beyond the G7 informed of developments and its planned policy responses. Commencing in the latter half of 2008, the US Treasury began initiating phone hook-ups with G20 Finance Deputies, which necessarily involved senior IMF staff, aligned with major developments as the crisis unfolded. For example, such hook-ups occurred in early September following the US announcement of conservatorship for Freddie and Fannie and then later that month, in the aftermath of Lehman's bankruptcy, regarding the US Administration's plans to remove toxic assets.

Meanwhile, the US was actively taking the lead in other forms of practical international cooperation. As \$US credit markets seized up, the US established bilateral swap arrangements to assist other jurisdictions in providing the

94 Department of the Treasury, Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, *Report on Foreign Holdings of US Securities, as of June 30, 2008*, April 2009, Table 5

95 GDP in constant 2005 US dollars. Dollar figures for GDP are converted from domestic currencies using 2000 official exchange rates. For more information, see The World Bank, *World Development Indicators*, (2013). EMDCs are classified under the IMF World Economic Outlook database country groupings.

\$US liquidity needed to support major non-US banks and financial institutions, many of whom were heavily exposed to the US market. The Federal Reserve announced swap lines with the ECB and Swiss National Bank, of \$US20 billion and \$US4 billion respectively, in December 2007, but both the amounts and the number of agreements were to expand rapidly over the next year. By the end of 2008, the Federal Reserve had put in place bilateral swap lines totaling over \$US750 billion, with thirteen central banks, including those of non-G7 members Australia,⁹⁶ Brazil, Denmark, the Republic of Korea, Mexico, New Zealand, Norway, Singapore, Sweden, and Switzerland. The US Fed had asserted itself as the de facto lender of last resort for the system, fulfilling the role that had been long debated for the Fund.

The G8 Summit in Heiligendamm, Germany, in June 2007, had presented a reasonably optimistic view of the economic outlook, including a positive spin on the

gradual correction of global imbalances, and hailed the first formal involvement of selected emerging markets — Brazil, China, India, Mexico and South Africa. The topics for discussion suggested by the G8, and agreed by the EMEs as the price of attendance — promoting and protecting innovation, preserving an open investment climate, including through promoting corporate responsibility, development responsibilities, and energy efficiency and security, linked to climate change concerns — reflected the very selective and somewhat condescending approach adopted by the G8 to its engagement with these EMEs, which clearly did not extend to acknowledging their stake in broad global economic or financial management.⁹⁷ The tone of the communique from the subsequent meeting of G7 Finance Ministers and Central Bank Governors in Washington, in October 2007, remained relatively sanguine, notwithstanding commissioning the Financial Stability Forum (FSF) to ‘...analyze the underlying causes

96 While Australian banks’ foreign exposures were predominantly denominated in Australian dollars, the Reserve Bank of Australia undertook to use the \$US swap line to assist in meeting regional demand for US currency in the Australian time zone trading area.

97 G8 Leaders, *Growth and Responsibility in the World Economy*, Summit Declaration, Heiligendamm, June 7, 2007

of the [financial] turbulence and offer proposals' to address specific policy issues in the area of financial regulation.⁹⁸ Through meetings in Tokyo and Osaka in February and June of 2008 respectively, the optimistic tone in G7/8 communiqués persisted, alongside growing recognition of '...uncertainty and downside risks'.⁹⁹ However, by September, under the chairmanship of Canada, a rare conference call meeting was thought necessary to discuss global financial markets and provide support for 'the extraordinary actions' taken by the US, and others, to address liquidity pressures and stabilize financial markets.¹⁰⁰

The FSF Report, delivered in April 2008, laid out a comprehensive set of sixty-seven recommendations, ranging across the full gamut of financial regulatory policy and institutional arrangements, including capital requirements, liquidity and risk management (including with regard to off-balance

sheet vehicles), good practice for prudential regulation, enhanced transparency and disclosure arrangements, enhanced valuation of assets and risks, the role of credit rating agencies, scope for improved information exchange and cooperation between national regulators, the role of central banks in providing liquidity, and improvements to practices for dealing with distressed financial institutions.¹⁰¹ The G7 endorsed these recommendations and urged their speedy and comprehensive implementation by national authorities.

Nevertheless, the FSF itself was a source of discomfort among non-G7 members. Established at the same time as the G20 Finance Ministers process as part of the G7's response to the Asian financial crisis a decade earlier, its membership was heavily weighted to the G7, and its operations far from transparent. Membership consisted of the central banks,

98 *Statement of G7 Finance Ministers and Central Bank Governors*, Washington, October 19, 2007

99 *Statement of the G8 Finance Ministers Meeting*, Osaka Japan, June 14, 2008

100 *Statement by G7 Finance Ministers and Central Bank Governors on Global Financial Market Turmoil*, September 22, 2008

101 Financial Stability Forum, *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*, April 7 2008

prudential regulators and ministries of finance/treasuries of the G7 countries, plus one representative each from Australia,¹⁰² Hong Kong SAR, the Netherlands, Singapore and Switzerland (considered the key financial centers outside of the G7), together with the ECB, the IMF and other International Financial Institutions, the OECD and representatives of international standard setting bodies for regulators and supervisors.

Through the course of 2008, as informal bilateral discussions intensified between non-G7 countries concerned to engage on responses to the gathering crisis, the role of the FSF attracted increasing attention. Opaque, with very unclear lines of accountability and a secretariat consisting of only a handful of staff, it nonetheless could tap significant expertise through access to the key agencies in its member governments. The original 1999 G7 decision to create the FSF, rather than task the

IMF with a greater role on financial regulatory issues, had reflected a judgment that effective cooperation on regulatory issues with direct impact on domestic financial systems required the equally direct ownership and engagement of sovereign governments and their responsible agencies, rather than any attempt to filter their interests through an international organization like the Fund.¹⁰³ However, suggestions in the G20 Finance Ministers context that the FSF should be invited to attend a G20 meeting to brief the wider membership on developments in the Financial markets met with resistance from non-FSF members of the G20, concerned to avoid lending legitimacy to a body which did not include them. The then chair of the G20 Finance Ministers' process, Brazil, took the opportunity on a number of occasions to welcome the involvement of the IMF with its universal membership in efforts to manage the crisis, for example, its participation in phone

102 In Australia's case, only the Governor of the Reserve Bank of Australia could attend. He could not send a deputy, nor could he be accompanied by anyone from either of the two financial sector regulators in Australia, the Australian Prudential Regulation Authority (APRA), or the Australian Securities and Investment Commission (ASIC). I presume similar restrictions applied to each of the other non-G7 members.

103 In practice, as the Fund was a member of the FSF, Fund staff representatives were actively in assisting the FSF, with its very limited staff resources, to prepare the G7 report.

hook ups initiated by the US, and to favorably contrast that with other ‘unnamed forums’ whose membership was more restricted.

THE FUND RE-ASSERTS ITS RELEVANCE

At the IMF, Dominique Strauss-Kahn had taken the reins as Managing Director in September 2007. As mentioned in the preceding section, he inherited a number of pressing issues, not the least of which was the need place the Fund’s finances on a sounder footing that did not rely on Fund lending to generate income for its administrative expenses. The latter had required agreement on a significant restructuring package, targeting sustained savings and staff reductions over the period 2009-11, and this was his primary priority at the beginning of 2008, a year that promised therefore to be a very disruptive one for the Fund and its staff. But Strauss-Kahn was also determined to refute

those who questioned the Fund’s continuing relevance, which meant both efforts to strengthen the voice of emerging markets and to demonstrate that the Fund was open to revisiting established orthodoxies in terms of its policy advice and operations. A number of these themes come together in a speech he gave while visiting India in early 2008, in which he highlighted the risk posed to the global economy by the financial turmoil in advanced economies, stresses the Fund’s strengths as a policy adviser and partner with high levels of technical expertise and universal membership, emphasizes the need to bolster the Fund’s legitimacy through governance reforms that give the EMEs an enhanced voice, and argues the case for fiscal stimulus in the advanced economies.¹⁰⁴

Strauss-Kahn’s early promotion of fiscal stimulus certainly helped reestablish the Fund as a leader in the evolving policy debate, and the Fund’s considerable technical

104 Dominique Straus-Kahn, Lessons from the Financial Crisis: Priorities for the World and for the IMD, Speech to the Indian Council of Research on International Economic Research (ICRIER), New Dehli, India, February 13, 2008

resources were quickly swung into action to elaborate and bolster the argument.

More generally, through the course of 2008, the Fund's priorities increasingly focused on efforts to help shape the policy debate in key economies, while strengthening the Fund's capacity to respond to the likely increase in demand for its services and resources. The number and value of new Fund programs, especially for members not eligible for concessional financing, had declined steadily and dramatically since the early part of the decade, from around SDR40 billion in 2002 to less than SDR1 billion in 2007.¹⁰⁵ As of July 2008, the Fund had only eight non-concessional financial arrangements in place with members, totaling SDR1.2 billion (or approximately \$US 1.9 billion) of which only three had been approved during 2007.¹⁰⁶ The potential for this trend to reverse was clear and there were challenges to be addressed regarding both the available human and financial resources. The stock

of available staff with significant experience of crisis management was likely to be depleted by redundancy packages agreed as part of the restructuring, and meeting the expected increase in demand for Fund services while delivering on the restructuring was going to be a serious test of management. (Ironically, the Fund's European Department would be most disadvantaged in terms of program experience as demand for Fund resources began to pick up towards the end of 2008, primarily from Central and Eastern European countries, requiring extensive internal re-allocation of staff.)

The Fund's financial resources were also likely to come under strain. As of the July 2008, the Fund's total usable resources amounted to \$US 265 billion, while the Fund's capacity to commit non-concessional resources over the coming year was considerably smaller, at \$US 207 billion.^{107,108} Given the potential depth and breadth of the crisis, as evidenced, for example, by

105 IMF, *Annual Report 2009: Fighting the Global Crisis*, (IMF 2009), Figure 3.2, Page 33

106 IMF Financial Activities – Update July 10, 2008, available online at www.imf.org/external/np/tre/activity/2008/071008.htm#tab1

the rapid growth in demand for Federal Reserve swap lines, and the looming potential impact on emerging market economies, it was obvious this fell well short of what might be needed.

Moreover, as demands for Fund assistance could arise suddenly, with little lead time, Fund Management invoked the Emergency Financing Mechanism, allowing for significantly truncated negotiation and approval times for Fund programs. In the event, the last quarter of 2008 saw these emergency arrangements applied in six of seven new programs¹⁰⁸ approved by the Executive Board involving commitments totaling a little over \$US 50 billion, and including the first Fund program for an advanced economy — Iceland — since the 1970s.

Under Strauss-Kahn, the Fund was also turning its mind to the adequacy of existing lending instruments, with an eye to the potential needs of EMEs. Many

inside and outside of the Fund had long thought there was a need for a pure liquidity instrument that could provide resources quickly to members' who faced contagion risks notwithstanding sound domestic policy settings. A decision to draw on such resources, it was hoped, would be seen as a sign of strength, avoiding the stigma that had come to be associated with a Fund program and reduce the need for countries to hold high precautionary levels of international reserves. An earlier attempt at such an instrument, the Contingent Credit Line (CCL) put in place in 1999 had focused on offering high performing countries a precautionary lines of credit, but had founded on the fact that actually drawing on the facility would nevertheless require an 'activation' decision by the Board, with a potential negative signaling effect, and had lapsed in 2003 without ever having been used. The important role played by the ad hoc system of bilateral swaps

107 Ibid

108 This depends on the Fund's stock of usable resources, provided by members' whose external position is sufficiently strong to be included in the Fund's Financial Transaction Plan (FTP), less commitments not yet disbursed and a buffer (20 %) to ensure that any member can have immediate access to their quota if confronted by a balance of payments need, thus preserving the monetary nature of the Fund.

109 For Georgia, Ukraine, Hungary, the Seychelles, Iceland, Pakistan and Latvia

put in place by the Fed underscored the need for such a liquidity mechanism, but also, for some, the desirability of more formal pre-existing, and multilateral, arrangements that could meet the same need. Ideas for some form of precautionary and/or short term liquidity tool were therefore again being explored by staff, along with scope for streamlining and simplifying the range of Fund instruments more generally, and reviewing the scope of conditionality that needed to attach to the use by a member of Fund resources.

THE G20 EMERGES TO TAKE THE LEAD

By the time of the 2008 Annual Meetings of the IMF and World Bank, in Washington, on October 11-13, demand for a clear signal that governments had a comprehensive, agreed and credible plan to address the global dimensions of the crisis was high. The Lehman's bankruptcy had seriously eroded the trust needed for markets to work, and subsequent policy announcements, such as passage of the US Toxic

Asset Removal Program (TARP) legislation had failed to bring any restoration of certainty. The sense that the global economy was fast approaching a tipping point from which it might again, as in the interwar years, take a generation to recover, was palpable in and around the meetings. It was also clear that, unlike the norm for such international meetings, the script for these meetings had not yet been written — and nor was it clear who might be able to take the lead in penning one that would resonate with the markets.

On October 8, the Bank of Canada, the Bank of England, the ECB, the Federal Reserve, Sveriges Riksbank and the Swiss National Bank had jointly announced collective action to lower interest rates. This was followed, on October 10, by the release of a Plan of Action by G7 Finance Ministers and Central Bank Governors. In a little over half a page of text, the G7 plan referred to the need for 'urgent and exceptional' action, and without specifying details, committed to 'take decisive action and use all available tools' to protect system-

ically important institutions, ‘take all necessary steps’ to unfreeze credit markets and provide liquidity, ensure adequate capital for banks and financial institutions and robust deposit insurance and guarantee programs, and to ‘take action, where appropriate’ to reinvigorate secondary markets for asset backed securities.^{110, 111} Notwithstanding US Treasury Secretary Paulson’s characterization of the Action Plan as ‘aggressive’,¹¹² markets focused more on the lack of new substance to back the rhetorical strength of the joint commitments. In its communique the next day, the IMFC had no choice but to echo and endorse the G7 commitments, adding however that it looked to the Fund to take the lead ‘in an inclusive setting’. An attachment set out more detailed guidance to the Fund for the cognoscenti regarding

its lending and surveillance role, and the importance of governance reforms, but if anything this served to underscore the absence of any definitive breakthrough capable of putting a floor under the continuing deterioration in confidence.¹¹³

As already noted, the shortcomings of the G7/8 process were already well understood, and proposals for alternative, broader groupings abounded. Both French President Sarkozy and German Chancellor Merkel had speculated about establishing a new leaders’ group, the latter suggesting the creation of an economic council akin to the UN Security Council.¹¹⁴ There were suggestions circulating that Sarkozy, with France then President of the EU, was considering convening a ‘G8 plus’ leaders’ gathering to take control of the international response to the

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- 110 G7 Finance Ministers and Central Bank Governors, *Plan of Action*, October 10, 2008, Washington DC
- 111 A separate G7 statement issued the same day, urged the Chinese authorities to allow accelerated appreciation of the RMB exchange rate, as a means of rebalancing the domestic economy and promoting external stability.
- 112 Statement by US Treasury Secretary Henry Paulson, following the Meeting of the G7 Finance Ministers and Central Bank Governors, October 10 2008
- 113 Communique of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, October 11, 2008
- 114 Harold James, *Op.cit.* page 140

crisis. UK Prime Minister, Gordon Brown, and non-G7 members such as Australia had begun to press the need to use the established G20 network and enhance its role by convening a G20 Leaders' meeting. (The UK was to take over the presidency of the G20 Finance Ministers for 2009.) The then Australian Prime Minister, Kevin Rudd, had been actively promoting this idea with his G20 colleagues, including in phone calls to US President Bush.

A meeting of G20 Finance Ministers and central Bank Governors had been hastily convened for the afternoon following the IMFC meeting. The Chair, Brazilian Finance Minister Mantega, opened the meeting by posing the question whether the G20 could play a better role in the crisis, and emphasizing the need to re-think the way the G20 was operating at that time. It was at that point that, having met that morning with the G7 Ministers, President Bush surprised the meeting by joining it and asking to address the participants. His two key messages were, first, that the US understood

its responsibility for the crisis and was determined to act boldly to fix it, and second, that global coordination was nonetheless essential and that all the countries represented in the room had a stake in ensuring that occurred. His comments struck a positive chord, with especially broad based support for the latter point, and appreciation of the opportunity to focus on the looming challenges posed for the EMEs. Within days of that meeting, the US took the initiative to convene the first G20 Leaders' summit, to be held in Washington DC on November 15, to discuss a collective response to the crisis.

FROM WASHINGTON TO PITTSBURGH, VIA LONDON

The US understanding of the need to broaden the ambit of the coordinated response beyond the G7 was clear, and the G20 provided a readymade forum which avoided the need for a protracted debate about which countries should be in and which not. The US initiative

also ensured that it would be best placed to influence both the agenda and the outcomes, rather than allowing, say, French President Sarkozy, to claim ownership through some alternative process.

The Declaration issued by the Washington G20 Summit¹¹⁵ appropriately placed great emphasis on the participants' shared values and principles. Moreover, while echoing the sentiment of earlier G7 communiqués on some issues, it clearly added perspectives and policy recommendations that reflected its broader and more diverse membership. In particular, the potential role for fiscal stimulus as part of a global coordinated macro policy response was highlighted. It would have been easier to obtain support among the broader G20 group for this, given that more of the economies represented had scope to undertake such stimulus, and the objections of austerity minded G7 members such as Germany could be more easily diluted. (In

addition, to maximize the effectiveness of fiscal stimulus would require a coordinated approach with broadly global involvement.) It added significant detail to the commitments made by the G7 regarding financial sector policies, by incorporating and spelling out the key recommendations of the earlier FSF report, already endorsed by the G7, into its forty-seven point action plan. It also established a more tangible prioritization of future work, and arrangements for Finance Ministers to monitor the delivery of commitments. (Australia had noted, for example, that earlier agreements reached in 1998 to address concerns regarding the risks posed by Highly Leveraged Institutions had been put to one side by the FSF and subsequently forgotten.) And, consistent with the rationale for the G20 itself, it sought to establish a broader agenda for reform of international financial governance. G20 Leaders acknowledged the inadequacies regarding FSF governance and

115 G20 Leaders, *Declaration of the Summit on Financial Markets and the World Economy*, (November 2008)

called for expanded membership of EMEs as a matter of urgency. They stressed the importance of closer collaboration between the FSF and the IMF, especially in developing a better integrated macro-prudential policy framework and providing early warning of future potential crises. Also as a matter of priority, they made it clear that the adequacy of Fund resources, and of the Fund's lending tool kit,¹¹⁶ would have to be addressed. Over the longer term, Leaders called for the Bretton Woods institutions to be 'comprehensively reformed so that they can more adequately reflect changing economic weights in the world economy and be more responsive to future challenges', and stressed the importance of 'vigorous and evenhanded' surveillance of all countries. All participants agreed to undertake

a financial stability assessment under the IMF's Financial Sector Assessment Program (FSAP).¹¹⁷

The most important contribution of the Washington G20 Summit was, however, arguably the signal provided by the fact that the Summit had actually taken place — that is, that Leaders of economies representing some two-thirds of the world's population and 88.1 percent¹¹⁸ of global economic activity had accepted responsibility for a coordinated response to the crisis and indeed had established a work program for officials to prepare for a further Summit before the end of April 2009.

The subsequent period leading to the April 2 2009 Summit in London was especially intense. Working Groups of officials had been formed to progress recommendations regarding enhancing financial

116 In Late October, 2008, the Fund had already announced the establishment of a new Short Term Liquidity Facility (SLF), aimed at addressing potential EME needs, that would allow members with good policy track records, access to financial markets and sustainable debt positions to draw up to 500 percent of their quota, for up to three months, with no conditionality.

117 Up to that point, of the G20 members, neither the US or China had undertaken such an assessment.

118 GDP in constant 2005 US dollars. Dollar figures for GDP are converted from domestic currencies using 2000 official exchange rates. For more information, see The World Bank, *World Development Indicators*, (2013).

regulation, reforming international cooperation, reforming the IMF and reforming the Multilateral Development Banks (MDBs) (Australia and South Africa agreed to co-chair the Working Group on reform of the Fund.) G20 Finance Ministers met in March, 2009, to discuss a progress report prepared by the UK Chair.

Meanwhile, for Strauss-Kahn and the Fund, the advent of the G20 Leaders' process was an opportunity to harness the political authority it offered, sadly lacking in the IMFC, to support the Fund's resurrection. As requested by the G20 Leaders, it quickly undertook and made public an analysis of the lessons to be learned from the crisis.¹¹⁹ It sought to strengthen its ties with the FSF, albeit while protecting its independence, via the development of a joint Early Warning Exercise that would meet the G20 Leaders' demand for strengthened capacity to forewarn of future crises. A dry run of such an exercise was presented to the Executive Board ahead of the April

IMFC meeting. It quickly followed up on the Washington Summit's reference to the potential role for fiscal stimulus, noting that its research suggested that 2 percent of global GDP was both warranted and manageable.¹²⁰ It would subsequently publish research in the lead up to the London Summit, noting the impact of the crisis on fiscal positions via slower growth, bank bailouts etc, documenting the collective discretionary fiscal stimulus of G20 members to that point (an estimated 1.5 percent of GDP in 2009, with a further 1.1 percent in the pipeline for 2010), and seeking to draw out the careful balance required between short term stimulus by those with the policy room to act, and the need for credible medium term plans to wind back such stimulus in due course and, in some cases, tackle deep seated structural issues regarding demographic pressures on entitlement programs, if sovereign debt problems were not to arise.¹²¹

Work on the reform of the Fund's

119 IMF, *Initial Lessons from the Crisis*, February 6, 2009

120 John Lipsky, *Towards a Post-Crisis World Economy*, Speech by the First Deputy Managing Director of the IMF to Paul H Nitze School of Advanced International Studies, Johns Hopkins University, November 17, 2008

lending tool kit and conditionality was accelerated, with the announcement in March of a package of significant reforms — including a streamlining of existing facilities and a less legalistic approach to conditionality, a simpler fee structure linked to maturities, higher access limits, — the centerpiece of which was the creation of the Flexible Credit Line (FCL), subsuming the Short Term Liquidity Facility introduced only a few months earlier. The FCL offered uncapped access to Fund resources for high performing economies with very sound domestic policy frameworks nonetheless facing contagion risks outside of their control, without any ex post conditionality. Importantly, in addition to removing the cap that had applied to the SLF, and lengthening the period of access, it also allowed for its use as a purely precautionary tool. The scope for precautionary access to the Fund's standard standby arrangements was also expanded. Unlike earlier attempts to offer

liquidity style instruments, the FCL quickly attracted potential users, with Mexico indicating its interest in seeking an FCL for up to 1000 percent of quota, approximately \$US 46 billion.

Increasing the Fund's resources was also, therefore, a high priority. As of early 2009, the Fund's usable resources had fallen to approximately \$US 230 billion, and its forward commitment capacity to under \$US 150 billion. The Washington Summit had indicated a willingness to ensure the Fund was appropriately resourced, and Strauss-Kahn was pressing for roughly a doubling, targeting useable resources of the order of \$US 500 billion.¹²² (Japan was the first to announce an offer of \$US 100 billion, by way of a bilateral loan, and quickly moved to finalize the borrowing agreement in February of 2009. In March, the European Union followed with an offer of a further €75 billion — also approximately \$US 100 billion). He was also conscious of the need

121 IMF, *The State of Public Finances: Outlook and Medium-Term Policies After the 2008 Crisis*, March 6, 2009

122 There was little science to this. A doubling was broadly seen as an appropriately ambitious target that might prove politically manageable. Nevertheless, some others were more ambitious. The then Australian Prime Minister, never one to aim low, had been testing the waters for an agreement to triple Fund resources.

to be seen to bolster the Fund's access to concessional resources for its low income members.

While happy to leverage this agenda off the G20, Strauss-Kahn was also keen to see governance issues, including the internal governance of the Fund, progressed. His response to the findings of the IEO study on Fund Governance referred to in the preceding section had re-opened a contentious debate about activating the Council of Ministers allowed for in the Second Amendment to the Fund's Articles of Agreement. The Board remained divided on this issue — something that was also being reflected in the deliberations of the G20 Working Group on Reform of the Fund — with the EMEs in particular suspicious that the Council proposal would merely distract from their key concern to address voting shares and representation. However, from Strauss-Kahn's perspective, neither the Executive Board nor the IMFC provided an effective mechanism for engaging the political backing

he felt necessary in guiding the Fund. He clearly preferred a longer term arrangement that involved an effective Ministerial forum institutionally linked to the Fund, and which therefore offered both legitimacy and some scope for the Fund to control the agenda, to the evolving de facto role of the G20. Nevertheless, the G20 was for the time being providing the necessary leadership, and Strauss-Kahn was happy to seek to position the Fund as the unofficial G20 secretariat on financial and economic issues.

The 'game changing' moment that all had been hoping for was to come at the London Summit, with the announcement of a significantly larger than anticipated package of \$US 1.1 trillion in additional financial resources to tackle the crisis, providing the required shock and awe to stabilize market sentiment.¹²³ This included, rather than a doubling, a trebling of Fund resources, to \$US 750 billion, a new SDR allocation of \$US 250 billion (thereby increasing the stock

123 G20 Leaders Statement, London Summit, April 2, 2009, paragraph 5.

of outstanding SDRs almost eight fold), together with agreement on a funding mechanism to increase the Fund's concessional resources and support for new MDB lending of at least \$100 billion to low income countries. In addition, G20 Leaders committed \$US 250 billion over the following two years to support trade finance to help reverse the worrying decline in trade being experienced for the first time in twenty-five years.

Other London outcomes included: agreement on a new body, the Financial Stability Board (FSB), to replace the FSF, with an expanded membership incorporating all G20 countries, existing FSF members, Spain and the European Commission; the re-assertion of G20 Leaders' resistance to protectionism, including financial protectionism, and commitment to conclude the WTO's Doha round of trade negotiations; an update on the progress being made against the earlier endorsed Action Plan in the area of financial sector regulation

and reform; and a concrete agenda to follow through on reform of the international financial institutions (IFIs), focusing on the reform of their 'mandates, scope and governance'. The latter included accelerated efforts to implement the Fund's quota and voice reforms and the parallel agenda at the World Bank, agreement that the heads and senior leadership of the IFIs should be appointed through an open, transparent and merit based selection process, and (by way of a possible allusion to the Council of Ministers) agreement that 'consideration should be given to greater involvement of the Fund's Governors in providing strategic direction to the IMF and increasing its accountability'.¹²⁴

By the third G20 Summit, in Pittsburgh, in September 2009, the Leaders felt emboldened to declare that their commitment to ensure recovery, repair financial systems and maintain the flow of capital, had worked.¹²⁵ The promised trebling of Fund resour-

124 Ibid, paragraph 20

es had been achieved, with an additional \$US 500 billion having been provided via borrowing arrangements with members, rolled into an expanded and enhanced New Agreements to Borrow (NAB).¹²⁶ Financial markets were showing signs of having stabilized, with corporate risk spreads having declined and interbank markets returning to pre-Lehmans spreads. There was evidence of a nascent recovery in global economic activity, and both the Fund's World Economic Outlook and Global Financial Stability Report espoused a degree of cautious optimism, albeit tempered by a realization that recovery from financial crises was invariably grudging and likely to lag improvements in the financial sector, and concerns about the pace of deleveraging and the challenge of transitioning from public stimulus led growth. Leaders were therefore keen to shift the focus to the recovery, under the rubric of 'a

framework for strong sustainable and balanced growth'.¹²⁷

On the Fund and governance, it re-affirmed that the Fund must remain a quota based institution and repeated the London commitment to accelerate the completion of the next review of Quotas, the 14th, by January 2011. In this context, it added further substance to the objectives for quota and voice reform, announcing the agreement that the aim was '...a shift in International Monetary Fund quota share to dynamic emerging markets and developing countries of at least 5% from over represented countries to under-represented countries', while 'protecting the voting share of the poorest'.¹²⁸ (From all accounts, negotiating this formulation had taken many hours of shuttle diplomacy by US officials between the Europeans and the BRICs in the margins of the communique drafting process.) The Statement also made more explicit

125 Leaders Statement, The Pittsburgh Summit, September 24-15, 2009, paragraph 5.

126 The NAB is an arrangement under which individual Fund Members agree to provide lines of credit to the IMF which could be activated when needed. Established in 1997, it consisted of lines of credit with 26 members totaling SDR 34 billion. Following the London G20 agreement to expand the Fund's resources, negotiations resulted in a greatly expanded list of 38 NAB participants, for a total amount of SDR 370 billion, or approximately \$US 585 billion as of September 2009.

127 Ibid, paragraph's 13-16, and 2-9 of the Attachment.

128 Ibid, paragraph 20

that the size and composition of the Executive Board needed to be addressed, along with ways of enhancing the Board's effectiveness and the Fund Governors' involvement in strategic oversight. And it repeated the mantra of an open, transparent and merit based appointment process for IFI heads and senior leadership.

Perhaps most importantly, G20 Leaders felt able to designate the G20 the premier forum for international economic cooperation. Any thoughts among the G7/8 that it would prove a temporary phenomenon, to be allowed to drift back into the wings once the immediate threat of the crisis had been addressed, had been shown to be unrealistic. The Pittsburgh Statement ran for twenty-three pages and reflected an expanding agenda, including energy security and climate change, and a broad range of development issues. The G20 Leaders' process had taken on a life, and qualified legitimacy, of its own.



Section IV

The Subsequent Reality — International Governance as a Hard, Slow Grind

The subsequent three years is best characterized as a period of creeping disenchantment with the G20's track record, as the realities of international economic and financial governance re-asserted themselves. On a number of fronts, momentum slowed and tangible results failed to live up to the heady expectations generated through the course of 2008-09. The emergence of the Euro Area sovereign debt crisis¹²⁹ also dramatically re-framed the immediate policy challenges, distracting policy makers and necessarily affecting priorities. In this context, this section will offer some observations and seek to draw out lessons from the subsequent progress

on selected issues — namely efforts to reform the international monetary system, enhance Fund surveillance and reform of international governance itself — as a means of understanding better the challenges of sustaining collective action by sovereign states, and the dynamics that have to be managed in this process. Efforts to support and enhance international cooperation are, if anything, more essential than ever, but expectations have to be realistic.

Of course, it remains an essential truth that all such efforts, to be effective, must be firmly anchored on the primary accountability of each national government to

129 Arguably this is not a new crisis, and rather the continuation of the 2008-09 financial disruption in a different form, as the losses and stresses in the financial sector have been shifted, directly and indirectly via contagion, to fragile Euro area public accounts and ultimately the European tax payer.

its domestic constituency. As is often said, all politics is local, and international politics is no exception. The increasingly hollow ring of G20 Leaders' calls for a successful conclusion of the Doha Round of Multilateral Trade negotiations — given prominence at Washington and repeated at each subsequent meeting through to Los Cabos (2012) — is testament to the fact that the engagement of Leaders may not, of itself, make the domestic politics any easier. (The adoption of a more pragmatic tone at the 2013 Summit in St Petersburg, looking to the prospect of a relatively limited agreement at the, then forthcoming, WTO Ministerial Conference in Bali as a positive 'stepping stone' and boost to confidence in the WTO process, was more encouraging — not least because the WTO was able to subsequently deliver).¹³⁰

Moreover, the experience under-

scores that such coordination is significantly more challenging in a multi-polar world — that is, one in which power and influence are shared increasingly evenly among a number of key players with divergent interests. The US remains the dominant political and economic presence at the table in all international financial governance forums, but both its capacity and its willingness to play a unilateral leadership role has been steadily eroding over many years. There has been much public comment recently about the apparent increasingly dysfunctional, divisive, and indeed, myopic nature of the US domestic policy debate. To the extent that domestic US politics continues in such a vein, it can only serve to further compound constraints on US international activism, especially in the area of what some are now calling 'economic statecraft'.¹³¹ In the context of international

130 This is not to say that it was not entirely appropriate that G20 Leaders chose at their first summit in Washington to emphasize their "shared belief that market principles, open trade and investment regimes, and effectively regulated financial markets foster the dynamism, innovation, and entrepreneurship that are essential for economic growth, employment and poverty reduction." Harold James (Op.cit) has written that financial crises invariably pose a fundamental threat to core social and economic values, and imply the inevitable rise of the forces of de-globalization. It was equally important that they highlighted the importance of rejecting protectionism, no matter how hard it was inevitably going to be in practice to resist all such pressures. But high level commitments without an agreed path for delivering them are a recipe for the rapid erosion of credibility.

economic and financial relations, there is no doubt that the US has become progressively more selective in terms of the issues on which it is prepared to use its political capital to pursue an agenda. At the same time, the emerging market economies are flexing their muscles and having a significant impact on the dynamics of decision making in the key international forums. Countries such as Mexico and the Republic of Korea, are progressively adopting a more confident, proactive approach on global economic and financial issues, and developing the domestic policy capacity to support this. Most notably, the BRICS (Brazil, Russia, India, China and the recent addition of South Africa) are steadily testing the potential for their own coordinated approach to issues, notwithstanding sometimes divergent national interests. The following discussion will highlight the difficulties in such an environment, once the shared sense of imminent crisis has passed, of moving beyond a

relatively low common denominator to lock in ambitious longer term reform.

G20 leaders' summits have become institutionalized in the period following the immediate crisis response. However, it is fair to say that none of the subsequent gatherings have re-produced the game changing sense of achievement — the 'headline moment' — that clearly emerged from the London summit.

This is not surprising. Such moments are rare in the regular interplay of international cooperation and coordination. The success of the London Summit had reflected a very specific set of factors. Not the least of these was the gathering sense of crisis, and the potential for a dramatic announcement regarding resources to change the nature of market perceptions. The fortuitous presence of key personalities in key positions also played a role: in particular, Gordon Brown, leveraging of the UK's incoming

131 For a discussion of what is meant by 'economic statecraft' see, for example, Jennifer Harris "Doubling Down on Economic Statecraft: What's at Stake for the United States and the World America Built", in Ian Bremmer and Douglas Rediker, eds. *What's Next: Essays on Geopolitics that Matter*, (Portfolio/Penguin, 2012)

presidency of the G20, alongside, in Dominique Strauss-Kahn, an equally forceful Fund MD, determined to re-position the Fund at the center of the crisis response efforts. And the G20 offered a readymade forum with broadly the right membership. It was also notable that the Leaders' Statement highlighted domestic policy settings in relatively general terms that could then be readily presented by national governments to their domestic constituencies as clearly in their national self-interest.

The Pittsburgh Summit later that year delivered on many of the key commitments made at London and added further detail on others, reflecting intense efforts by officials on a broad agenda in what was, by the normal standards of cooperative international activity, an extraordinarily tight timetable. But the signs of a broadening G20 agenda hinted at one of the tensions inherent in the successful involvement of Leaders, and the natural desire to preserve momentum — how to manage the inevitable desire to follow up with new meaningful outcomes,

worthy of Leaders' time and commitment, without over burdening the process and undermining its core strengths, namely the strong sense of personal ownership and engagement by the Leaders themselves.

Since Pittsburgh, G20 Leaders have met five further times — in Toronto and Seoul in 2010, before reverting to an annual meeting cycle for Cannes in 2011, Los Cabos in 2012, and St Petersburg in 2013 — while G20 Finance Ministers and Central Bank Governors, previously used to meeting once a year, have met fourteen times, including five times during the course of 2011 alone in preparation for the Cannes Summit. The agenda has been broadened to include, among other things: energy security and climate change; a commitment to phase out (over the 'medium term') inefficient fossil fuel subsidies; food security; combating corruption; efforts to strengthen the global safety net for countries facing potential external shocks; financial inclusion; a broad development agenda; broad reform of the international monetary sys-

tem; and protection of the marine environment. The agreements reached on all of these fronts have been commendable, but tangible progress has been challenging, contributing to an overall sense of slowing momentum.

One significant element in the international reform agenda emerging from the crisis which I do not intend to canvass in any detail is that of the agreed efforts directed at financial sector regulatory reform. Doing justice to this broad ranging and highly technical work stream is well beyond the scope of this paper. Nevertheless, it should be acknowledged that there is a case for claiming this as a success story for the G20. Broad agreement on a clear reform agenda has been established, accountability for delivering the agenda, via the newly created and expanded Financial Stability Board (FSB) and relevant national agencies is clear, and the latter are pressing ahead the work of implementation. Even so, as the

implementation challenge has become increasingly complex, and in some cases increasingly intractable (e.g. the vexed issue of 'too big to fail'), and new conceptual issues have emerged,¹³² the 'success story' has become increasingly qualified.

Moreover, each step along the way has raised a range of idiosyncratic challenges, and potential sensitivities to be managed, at the national level. Certainly, in some cases, the domestic political agenda threw up proposals which proved to be deeply divisive and distracting, such as the UK push for a new tax on financial sector institutions.

In the Euro Area, implementation of the financial regulatory reform agenda necessarily became hostage to the more immediately pressing and existential challenges posed by the sovereign debt crisis. The IMF's October 2012 Global Financial Stability Report documents in some detail the extent to which policy actions

132 For example, the IMF Economic Counsel, Olivier Blanchard has recently posed questions as to whether the new powers being proposed for Central Banks, under the rubric of macro-prudential policy, are compatible with the orthodoxy over the last twenty years of central bank independence, while the IMF's October 2012 Global Financial Stability Report foreshadowed the need for some difficult discussions on the scope for direct restrictions on the choice of business model by private financial institutions. (Page 75)

required to address the immediate crisis will also have delayed the required 'reboot' of the financial system, while further reinforcing national fragmentation of financial markets within the Euro Area and compounding the challenge of tackling the issue of institutions that are 'too important to fail'. In many respects, notwithstanding intensive efforts to progress the agreed reform agenda, the operation of the global financial system, and the risks it embodies, remain largely unchanged from the eve of the crisis.^{133, 134}

As already noted, the FSB has had primary carriage of this agenda at the behest of the G20.¹³⁵ It has had to do this while managing

the implications of its enhanced membership,¹³⁶ — notably, the FSB's newly re-constituted Steering Committee has 41 members! Anecdotal reports suggest that the debates continue to be dominated by highly parochial and often arcane disputes between the earlier core FSF membership, which the EME's approach with a mixture of skepticism and suspicion. The latter has given rise to pressure on the G20 to acknowledge the potential 'unintended consequences' for EMEs of financial regulatory reform, acknowledged at Los Cabos.¹³⁷ A report prepared on behalf of the FSB¹³⁸ highlighted concerns that the Basel III capital framework, proposed require-

133 International Monetary Fund, *Global Financial Stability Report; Restoring Confidence and Progressing on Reforms*, (IMF, October 2012), Chapter 3.

134 It can be argued that the domestic political imperative following the crisis for concrete action distorted the agenda in favor of rule changes as opposed to focusing on less tangible efforts to strengthen the quality of supervision.

135 This has reflected the judgment, consistent with the rationale for the initial creation of the FSF, that financial sector regulatory issues require a high level of technical expertise and touch such fundamental domestic nerves that the direct involvement of national regulators is needed,

136 Membership of the FSB is institutionally, rather than country based. Hence, both the Reserve Bank of Australia and the Australian Treasury are each members in their own right. See Domenico Lombardi, *The Governance of the Financial Stability Board*, (Brookings Institution September 2011) for a good primer on FSB governance issues.

137 G20 Leaders' Declaration, Los Cabos, 18-19 June, 2012, paragraph 45

ments for Global Systemically Important Institutions (G-SIFIs), and recommendations regarding regulation of over-the-counter (OTC) derivatives trading may raise costs and /or constrain the supply of credit and intermediation services to these emerging markets, while other aspects of the reform agenda, for example the agreed liquidity buffer requirements, fail to acknowledge EME country-specific circumstances.¹³⁹

In part, these concerns turn on differing interpretations of unintended vs. intended consequences of a number of the reforms, as more conservative pricing of risk and constraining the availability of credit is precisely what these reforms aim to achieve. However, this too underscores the challenge of ensuring common understanding and broad buy-in by the full expanded FSB membership to agreed reforms in this area — an area at the core of the coordinated international response to the crisis.

Overall, the experience to date in this area underscores two key challenges. First, the difficulties inherent in implementing what is a highly complex and interrelated set of reforms in a domestic context are significantly compounded by the need to accommodate different cultural approaches to regulation, different financial domestic structures, and differences in the perceived political trade-offs etc. Second, while it is essential to involve the emerging markets in this process, it is also inevitable, given their differing stages of financial sector development and limited capacity to engage on what are often complex issues relating to the regulation of far more sophisticated financial systems, that their involvement will further complicate each of these challenges. In broad terms, the EME's primary focus is likely to be on keeping the advanced economies honest in addressing the latter's perceived past shortcomings while not unduly limiting their own regulatory flexibility or imposing, in

138 Financial Stability Board, *Identifying the Effects of regulatory Reforms on Emerging Markets and Developing Economies: A Review of Potential Unintended Consequences*, Report to the G20 Finance Ministers and Central Bank Governors, 19 June, 2012.

139 This concern was not limited to EMEs. Australia also argued that implementation arrangements would have to allow for circumstances where a history of sound fiscal policy met a very limited supply of available government securities to provide acceptable low risk, liquid assets

their view, unnecessary costs on their own development models.

The remainder of this section will explore in greater detail the experience since 2009 in three key areas of the reform agenda adopted by the international community in the wake of the crisis — efforts to reform of the international monetary system, the related issue of enhancing Fund surveillance, and progress of the agreed governance reform agenda — and the lessons to be taken from this experience.

REFORM OF THE INTERNATIONAL MONETARY SYSTEM (IMS)

Little traction for France's Grand Designs

The French Presidency of the G20, through 2011, arguably remains responsible for setting the most daunting yardstick for G20 'success', no less than a broad review of the IMS. The experience

on this broad ranging agenda is particularly telling in terms of understanding the limitations and practicalities of international financial governance in the period since the crisis. Notwithstanding extensive analytical work by the IMF staff, strong advocacy for fundamental reform from high profile and eminent commentators such as the Palais Royale Initiative,¹⁴⁰ and no shortage of discussions between officials at both the IMF Executive Board and in the G20 context, the eventual agreement on tangible outcomes must be described as modest.

The French interest in such an ambitious agenda no doubt reflected a national predilection for 'grand systemic visions', echoing President Sarkozy's earlier call for a New Bretton Woods, combined with the domestic appeal of an agenda that sniped at the US's perceived privileged position as the source of the primary reserve asset for the global economy. French officials saw 2011 as a year

140 The Palais Royale Initiative contained proposals for reform endorsed by a group of former central bank governors, Ministers for Finance, Fund Managing Directors and other luminaries. See Jack T. Boorman and Andre Icard, eds. *Reform of the International Monetary System: The Palais Royale Initiative*, (Sage publications, India, 2011)

of transition for the G20, in search of a more medium term agenda. (Ironically, Leaders were to find themselves at the Cannes Summit again pre-occupied with crisis management concerns, in particular the challenges posed by the Greek authorities' decision to call a referendum on the commitment to remaining in the Euro Area, and by the Berlusconi government's eroding credibility regarding Italy's sovereign debt burden, alongside expectations that the Fund would soon, again, need to be able to demonstrate a boost to its resources.¹⁴¹

The agenda advocated by the French G20 Presidency was a broad one. It touched on fundamentally challenging issues, both conceptually and politically. These included: the design of the global adjustment mechanism to ensure acceptable burden sharing between deficit and surplus economies; options (including potential amendments to the IMF's Articles

of Agreement) to strengthen collective oversight of global capital flows; development of a systemic liquidity provision mechanism for the global economy (to replace the need for ad hoc central bank swap mechanisms such as those initiated by the Fed at the height of the crisis); and exploration of complements/alternatives to the US dollar as the international reserve asset, including an expanded role for the SDR.

Intensive and broad ranging discussions took place within the Fund's Executive Board, commencing in March 2011,¹⁴² based on a series of technical papers prepared by Fund Staff. Few if any of the ideas or issues were new, with many of them having been earlier canvassed in discussions on the review of the Fund's Mandate in early 2010.¹⁴³ Parallel discussions, covering essentially the same ground, were to take place in G20 working groups and at the G20 Deputies level. However, in

141 As will be discussed in more detail below, unlike London, on this occasion at Cannes, agreement could not be reached and Leaders were obliged, in the vernacular of American football, to 'punt', commissioning their Finance Ministers to develop options "by their next meeting".

142 *Strengthening the International Monetary System: Taking Stock and Looking Forward*, (IMF, March 23, 2011)

143 *The Fund's Mandate: An Overview*, (IMF, January 22 2010)

contrast to, say, reform of Fund quota shares, an issue on which the conceptual issues were clear and the sticking point was largely political, the G20 process had no particular comparative advantage in resolving the conceptual issues underpinning the IMS debate.

Moreover, the issues involved went to fundamental questions of sovereignty — as the Fund staff put it, ‘an IMS reformed along these lines might lessen policy discretion for individual countries, but should yield a more stable system.’¹⁴⁴ In fact, this probably understated the trade-off that had to be managed. The promise of increased stability was never going to be sufficiently tangible in terms of the task of persuading domestic constituencies to buy into the loss of sovereignty which was more than just a possibility. Not surprisingly, while many Executive Directors were sympathetic to the intellectual points being made by Fund Staff, consensus on the required extensive reform

efforts that would likely take many years, cut across national policy discretion and prove very difficult to explain to domestic constituencies, proved elusive. Indeed, the fact that the existing system, however imperfect, had proven capable of mustering the necessary policy responses to avoid the worst case consequences of the crisis itself undermined the scope for agreement on a radical reform agenda — the existing system was not considered sufficiently broken.

At the same time, key country stakeholders, in both the discussions at the Fund Board and in the G20 context, clearly harbored reluctance to accede to the Fund’s clear institutional ambitions in key areas. For example, there was little or no appetite to fuel Fund ambitions to position itself as a global macro-prudential regulator, amidst considerable uncertainty as to what that might mean in practice. EMEs were especially reluctant to reopen any debate about a Fund

144 *Strengthening the International Monetary System: Taking Stock and Looking Forward*, (IMF, March 23, 2011), page 1

role regarding the ‘oversight’ of capital flows, an issue which will be discussed in more detail below as part of Fund Surveillance. And there was little enthusiasm for expanding a reserve currency role for the SDR.

Rather, at the Cannes Summit, the Leaders process produced a significantly scaled back level of ambition, and a focus on pragmatic small steps, rather than grand reforms. Concerns about the efficacy of existing global adjustment mechanisms were to be rolled into a review of Fund surveillance. In this context, Leaders re-affirmed their faith in a flexible exchange rate system, in effect confirming that the ‘non-system’ ushered in in 1978 in the wake of the breakdown of Bretton Woods remained the only viable option, while encouraging greater acceptance of market determined outcomes. Debate about capital flows produced non-binding ‘coherent conclusions’, by way of guidance for domestic policy,

although these failed to resolve the operational implications for the IMF. (The issue of the Fund’s role regarding capital flows will be discussed in greater detail in a later section) There was support for further piecemeal refinements to the IMF’s instruments, including the creation of a Precautionary and Liquidity Line (PLL), to address concerns about access to liquidity on a selective, case by case basis. Nothing was said about the SDR, beyond a restatement that its currency composition should continue to reflect ‘the role of currencies in the global trading and financial system, based on ‘existing criteria’, and reviewed in 2015 or earlier,¹⁴⁵ effectively confirming a framework and implied timetable for considering the inclusion of the Chinese renmimbi (the currency of the world’s second largest economy) in the basket, which currently consists of the US dollar, Euro, Japanese Yen and British Sterling.

Both the creation of the PLL, and the decision to eschew any

145 Communique, G20 Leaders’ Summit, Cannes – 3-4 November 2011, , paragraph 8

enhanced new role for the SDR are worthy of some further examination. In both cases, the debate touched on fundamental issues regarding competing paradigms of international economic governance, and revealed much about the dynamics of cooperation in this space.

SDRs — cornerstone for a New Reserve System or irrelevance?

Created in 1969, by the first Amendment to the Fund's Articles of Agreement, in the context of concerns at the time about an emerging dollar shortage,¹⁴⁶ the SDR (or Statutory Drawing Right) is a source of unconditional liquidity issued by the Fund. Its value is determined with reference to a basket of the four national currencies listed above. Fund members with sufficiently strong balance of payments positions are designated to stand ready to exchange hard currency for SDRs, at the exchange rate determined by daily movements in this basket.

The first Amendment also introduced a requirement that the Fund promote the use of SDRs.¹⁴⁷ Notwithstanding this, however, prior to the exceptional allocation of \$US250 billion in SDRs agreed as part of the London Summit package of enhanced financing to tackle the crisis — and viewed as an extraordinary response to an extraordinary set of circumstances — there had been relatively little interest in an expanded role for the instrument. Historically, it had rarely proven possible to convince the required 85% voting majority of the membership that there was a shortage of global liquidity which could justify an allocation of SDRs, as required under the Fund's Articles.

However, questions about the role of the SDR touched on more fundamental questions regarding the nature of international economic governance in a world of sovereign states. The SDR is neither a currency nor a claim on the IMF, but rather a line of credit.

146 Such concerns were quickly overtaken by the threat of a dollar glut, fueled by loose US fiscal policy, which contributed significantly to the eventual demise of the Bretton Woods System.

147 IMF, *Articles Of Agreement*, (IMF, 2011), Article VIII, Section 7.

Holders of SDRs can choose to convert them into usable currencies by exchanging them with other Fund members. The ultimate source of the liquidity therefore remains the national central banks of the jurisdictions that issue the component currencies. Those that envisage scope for the SDR to take on a more significant role, and perhaps emerge as the cornerstone of a reformed international reserve system, implicitly envisage the Fund taking on more of the qualities of a global central bank, with the capacity to create liquidity independent of the national authorities that issue the component currencies. While this may have some intellectual appeal, as a practical option in a world in which ultimate authority lies with nation states, it remains largely fanciful.

Such proposals have tended to receive short shrift in the Executive Board. On this occasion, while there may have been some sympathy, for both technical and

political reasons, with the desirability of reducing the reliance of the international reserve system on selected national currencies, and in particular, on the US dollar, it was notable that the US did not need to lead the arguments against an expanded role for the SDR; there was extensive and broad based skepticism from all quarters around the table.¹⁴⁸

The second dimension to the SDR issue touched on in these discussions, related to the desirability of facilitating an expanded reserve currency role for the Renmimbi, alongside the US dollar and Euro, in keeping with China's rapidly increasing economic weight in the global economy. The Agreement reached at Cannes to consider the inclusion of the Renmimbi, on the basis of the established framework, reflected an appropriate acknowledgement of China's increasing economic influence and weight. However, as set out in Box IV -1, this may prove to be more symbolic than real, while the

148 I noted that it may be no coincidence that the discussion had been scheduled for April 1, i.e. April Fool's day, recalling that the noted MIT economist, Charles Kindleberger, had reputedly once suggested that the SDR was to the US dollar what Esperanto was to the English language, an artificial construct without the organic or historical qualities necessary for its popular acceptance (either as a lingua franca or as a reserve currency). A similar comparison was made in Chinn and Frankel, *Will the Euro Eventually Surpass the Dollar As Leading International Reserve Currency?*, NBER Conference Paper, June 2005.

path to an enhanced role for the Renmimbi remains uncertain.

Moreover, it is important to stress that inclusion of the Renmimbi or any other currency in the SDR basket is a reflection of that currency's international use; it does not of itself transform that currency into a reserve asset. The key impediment to an expanded role for the Renmimbi lies not in international agreements or administrative rules, but in the need to tackle fundamental domestic financial sector reform. The international acceptance of the Renmimbi, or any other national currency, as a reserve asset by the financial markets depends fundamentally on the depth and openness of its national capital markets. The Chinese authorities' apparent objective to internationalize the Renmimbi will therefore require them, in time, to tackle entrenched domestic financial sector rigidities which go to the heart of China's current growth model.

The PLL — A Strengthened Global Financial Safety Net?

The call by G20 Leaders at Pittsburgh for the Fund 'to continue to strengthen capacity to help members cope with financial volatility...and the perceived need for excessive reserve accumulation'¹⁴⁹ had laid the foundation, by the time of the Korean Presidency in 2010, for a focus on what had come to be labelled the Global Financial Safety Net (GFSN).

The trebling of the Fund's resources agreed at London was obviously a key plank in any such safety net, alongside well established elements such as the Fund's surveillance arrangements and balance of payments financing mechanisms. Underpinning all of these established elements was a recognition that the core of any such safety net had to be sustainable domestic economic policy settings. Nevertheless, the GFSN agenda reflected a perception that there was a need to bolster existing arrangements

149 G20 Leaders' Statement, The Pittsburgh Summit, September 24-25, 2009, paragraph 20

Box IV-1 – Expanding the SDR Basket to Include the Renmimbi

The existing criteria for including a currency in the SDR basket, re-affirmed by G20 Leaders at Cannes, requires a currency to be judged “freely usable,” that is “widely used to make payments for international transactions” and “widely traded in the principle exchange markets,” consistent with the desire to strengthen the SDRs appeal as a reserve asset.

The Cannes Summit was notably silent on whether the Fund should be open to expanding the number of currencies in the basket beyond the existing four, or whether the possible inclusion of new currencies would have to be at the expense of an existing currency included in the basket. While international foreign exchange market turnover denominated in Renmimbi has grown strongly in recent years, in 2010 it still accounted for only 0.4% of total foreign exchange turnover, and was ranked 17th overall in terms of active trading, compared to 6.4% for sterling, the least traded of the four SDR basket currencies. (See the IMF paper, **Eligibility Criteria for SDR Currency Board – Note for the G20 International Monetary System Sub-Working Group on Global Liquidity Management**, August 2011.)

There is clearly scope for international use of the Renmimbi as a medium of exchange and store of value to continue to expand rapidly, especially in the first instance within Asia. Moreover, the Chinese authorities have indicated an interest in promoting its increased role, especially in trade related transactions, principally by facilitating its convertibility via bilateral arrangements with selected trading partners. Nevertheless, official Chinese views on the extent to which the Renmimbi should take on a reserve currency role, and the pace at which this should occur, remain ambiguous. The Chinese Fund Executive Director acknowledged, during the Board discussion, that the benefits of reserve currency status were not unambiguous, bringing responsibilities and policy constraints as well as perceived privileges.

to overcome shortcomings revealed by the crisis response. In particular, the experience of relying on the Fed to make available bilateral swap arrangements to provide access to \$US liquidity, had been unsettling for a number of countries, especially those such as Korea which had not been among the first group to whom swaps had been offered and who therefore had had to contend with the costs of uncertainty.

However, reaching agreement on tangible initiatives that could be presented as making material and practical improvements to existing arrangements was to prove difficult. Some elements were widely seen as non-contentious, sensible and timely. For example the agreement in 2011 to establish principles of cooperation between the Fund and the various regional financial arrangements that have been established over recent years, was a pragmatic response to the Fund's increasing entanglement with the ECB and European Commission in dealing with the Euro Area sovereign debt crisis. (This didn't mean there was

not scope for skepticism as to just how effective such principles would be in managing the political pressures associated with such partnerships.) But the core elements of the agenda being put forward by the proponents of a strengthened GFSN were to prove significantly more contentious, and raised very similar fundamental questions to those associated with the role of the SDR .

In particular, the debate turned on widely divergent views regarding both the desirability and the practicality of developing a comprehensive, structured framework for dealing with future potential systemic liquidity crises.

The Fund's creation in 2009 of the FCL, a precautionary credit line available for very strong performing economies confronting potential exogenous external stability risks not of their making, had been seen as a positive step. Analysis suggested that the existence of the FCL, and its use in the case of Mexico, Poland and Columbia, had had a calming effect on market risk assessments, and had provided

room for stabilizing adjustments to domestic policy settings.¹⁵⁰ Nevertheless, debate had continued regarding the efficacy of the FCL. The fact that there had been no further requests from members to use the instrument, beyond these first three, necessarily raised questions, in particular whether such an instrument should or could be expected to substitute fully for self-insurance by countries (that is, high precautionary holdings of international reserves). Paradoxically, some within the Fund's membership were also beginning to express concerns regarding the implications for the Fund's available resources. (The FCL involved locking up a potentially significant share of the Fund's available resources for a small group of strongly performing members at a time when the likely demand for Fund assistance from members facing immediate, rather than potential, external funding needs was likely to increase.)

It was clear, therefore, that the col-

lective 'buy-in' of the Fund membership in support of the concept of the Fund as a provider of precautionary insurance-like support, and acceptance of the implications of being in this line of business, in particular for the Fund's resource needs, was, at best, not deeply rooted. Nonetheless, cheered on through the course of both the Korean (2010) and French (2011) G20 presidencies to look for options that could strengthen the GFSN, Fund Management and Staff placed a range of more far reaching proposals on the table.¹⁵¹ Central to these proposals was a vision of the Fund playing the key role in a more structured set of mechanisms for responding to future systemic liquidity crises, addressing perceived 'gaps' exposed by the ad hoc responses which had unfolded through the course of 2008-09. This vision was to manifest itself in the proposal for a Global Stabilization Mechanism (GSM), which envisaged a process whereby the declaration of a systemic crisis would trigger

150 IMF, *Review of the Flexible Credit Line and Precautionary Credit Line*, (IMF, November 1, 2011) pp 9-13

151 See, for example, IMF *The Fund's Mandate – Future Financing Role*, (IMF, March 26, 2010) and the supplementary paper, *The Fund's Mandate – Future Financing Role – the Current lending Toolkit and innovative Options*, (IMF, March 26, 2010)

access to a range of exceptional support mechanisms.¹⁵²

The debate on the GSM revealed deeply divided views on at least two core issues. Should one attempt to develop a predictable set of support mechanisms to deal with what would inevitably be an unpredictable future crisis? And, should, or indeed could, the Fund aspire to a role in providing global liquidity in a systematic way, effectively taking on the central role played by the US Federal Reserve and national central banks during the crisis, via establishment of a network of bilateral swap arrangements? (As already noted in the context of the SDR, technically, the Fund cannot create liquidity, but only play a role in its allocation.)

While Fund Staff pressed the case strongly for a GSM, or something of its ilk, through the course of 2010-11, with no doubt a mixture of intellectual commitment and institutional ambition, it was met with broad if not universal skep-

ticism among the membership. Doubts were expressed on a range of both philosophical and practical grounds. How feasible would it be in practice for the Fund to be able to mobilize liquidity any faster than had proven the case under the leadership of the Fed Reserve during the crisis? Given that future crises would again, most likely, manifest themselves as a crisis of confidence rather than purely a lack of liquidity, would such a framework or mechanism have the necessary credibility? Was a degree of ambiguity in any collective response to a future crisis a useful means of limiting the ever present issue of moral hazard? To what extent was this primarily a Fund grab for greater institutional influence? What would be the signaling impact of a decision to activate such a mechanism, and equally importantly, how would one manage the inevitable pressures to either de-activate prematurely or maintain access to exceptional lines of support for too

152 IMF, *The Fund's Mandate – The Future Financing Role – Reform Proposals*, (IMF, June 29, 2010)

long?

It is worth noting that this debate did not divide along what might be considered traditional advanced economy/emerging market and developing economy lines. A number of traditionally conservatively minded advanced economies and those protective of their national policy prerogatives (in particular the US) found themselves aligned with some of the larger equally conservative EMEs. The latter's apparent skepticism regarding strengthening the Fund's potential future role was no doubt in part influenced by the knowledge that the potential users of any such facility were increasingly likely to be advanced economy Fund members, specifically the Europeans. It is arguable that, under a governance structure that allowed the EMEs a greater voice, some resistant EMEs may have been more open to the proposals. But one had the impression that EME skepticism went deeper than this, and was based on an instinctive resistance to strengthening international architecture at the expense of domestic sovereignty.

On the other side of the debate were those EMEs, particularly Korea, which had felt most exposed during the initial days and weeks of the crisis, confronted by a shortage of US dollar liquidity and uncertain as to whether they would be included in the network of Fed bilateral swaps being put together at that time, together with France and those other advanced economies traditionally more open to grand solutions.

While certain elements of the Staff's proposals, if adopted, would have required amendments to the Articles or a special majority of 85% of the Fund's voting power, the core of the GSM could have been put in place with a simple majority. Still, the necessary consensus did not exist.

Driven by the inexorable pressure for 'deliverables' — and a desire to ensure that decisions on new Fund instruments were seen to be taken at the Fund and not imposed by the G20 — attention increasingly turned instead to options for fine tuning the FCL and filling in perceived gaps in access to similar

precautionary and/or liquidity support for fund members facing potential contagion risks but not quite meeting the very high qualification thresholds established for the FCL. In September of 2010, the Fund announced agreement on a set of reforms to the FCL, extending its potential duration and removing the non-binding but nonetheless constraining normative ‘cap’ on access of 1000 percent of quota, in order to enhance the FCL’s ‘reserves-like’ qualities. It also announced agreement on the creation of a new instrument, the Precautionary Credit Line (PCL), available to provide similar precautionary support, albeit with more constraints and some modest degree of ex post conditional-ity, for ‘...countries with sound fundamentals and policies, but moderate vulnerabilities.’¹⁵³ While initially resisting Staff proposals for a lending instrument that could provide short term liquidity support, continuing pressure to address liquidity issues in some way, including from the G20,

led the Fund’s membership to subsequently return to this issue through the course of the next year, replacing the PCL with the Precautionary and Liquidity Line (PLL), a facility which included such a feature.¹⁵⁴

The agreement on the PLL had not proven to be easy and represented a compromise which left many questions and issues unanswered, while posing new operational uncertainties. It is unclear whether the PLL will reduce or exacerbate concerns regarding the stigma countries perceive to be associated with the use of Fund resources. Layering of eligibility requirements inevitably raises potential concerns — it may be that potentially eligible countries may consider access to the PLL a better alternative to use of a traditional Fund Stand-by arrangement, but it is equally possible that they will be concerned about the potential stigma of being seen not to be

153 See *The Fund’s Mandate—Future Financing Role*, Public Information Notice No. 10/124, September 3, 2010

154 See *The Fund’s Financing Role—Reform Proposals on Liquidity and Emergency Assistance and the Review of the Flexible Credit Line and Precautionary Credit Line*, Public Information Notice, No. 11/152, December 7, 2011

eligible for the FCL. Notwithstanding efforts to clarify the distinction between the two facilities in terms of eligibility requirements, the latter continue to be based on essentially qualitative judgments — the FCL requires ‘very strong fundamentals and policies, while the PLL/PCL requires these to be ‘sound’. The signaling effects of accessing the PLL are therefore necessarily uncertain, while to date the operational ‘case law’ is scant. There has been only one request for access to the PCL/PLL, by Macedonia, approved by the Executive Board in January 2011, and the short term liquidity line remains untapped.

The final agreement was not reached until after the proposal put forward by Staff had been endorsed, in broad terms, by G20 Leaders at Cannes.¹⁵⁵

Most stakeholders were ultimately prepared to put their skepticism to one side, in the interests of a deal. Indeed, it would be fair to say that for many, agreement to the PLL represented a least worst compromise where all recognized that some tangible outcome was needed, with several chairs privately expressing skepticism that any country was ever likely to face circumstances in which access to the liquidity facility would be an attractive option.¹⁵⁶ Those still vocal in their resistance to the deal at the close were primarily the non-G20 voices around the Executive Board, although at least one G20 EME representative continued to express strong reservations.

Overall, the process produced an uncomfortable political compromise, driven by the pressure for a deliverable, with form arguably given primacy over substance, and relatively little focus on an overall

155 Communique of G20 Leaders’ Summit, Cannes, 3-4 November 2011, paragraph 15.

156 Access is limited to six months, and normally 250 percent of quota. In addition to sound fundamentals and policies, to be eligible, a country must also demonstrate it does NOT face i) sustained inability to access international capital markets; (ii) a need for large macroeconomic or structural policy adjustment (unless such adjustment has credibly been launched before approval); (iii) a public debt position that, with high probability, is not sustainable in the medium term; or (iv) widespread bank insolvencies. In exceptional circumstances, where a country faces an increased actual or potential balance of payment need that is of a short-term nature due to the impact of exogenous shocks, including heightened regional or global stress conditions, access of up to 500 percent of quota may be requested.

agreed coherent strategy to shape the outcome.

The further stratification of new Fund instruments cut across continuing efforts on other fronts to stream line and simplify the Fund's tool kit. Certainly, it is at least arguable that there was scope to make much more flexible use of the Fund's core instrument, the Standby Arrangement, to meet the likely needs of members for precautionary and/or liquidity support, but this would not have provided the perceived need for some revised 'branding'. At the same time, the Fund membership has yet to explicitly address, and establish a clear consensus regarding, the implications for the Fund of it being in the insurance and liquidity business, in particular in terms of resource implications. Concerns continue to be expressed about the absence of clear exit strategies for FCL users. Such sentiments are no doubt fueled by the fact that the continuing combined commitments to Mexico, Poland and Columbia currently reduce the Fund's Forward Commitment capacity by SDR

73 billion. Many would not have anticipated that the FCL would in practice involve such a large and open ended commitment to strong economies at the potential expense of members facing more immediate and serious external financing challenges.

Lessons

Overall, it is hard to avoid the conclusion that the G20 decision to commit itself and the Fund to a broad ranging review of the IMS through the course of 2010-11 was something of an indulgence on the part of those pressing this agenda. Certainly, its proponents seriously misjudged the appetite for far reaching reform as the sense of imminent catastrophe eased in the aftermath of 2008-09. The perceived success of those efforts itself dampened interest in fundamental root and branch reform of the IMS — following through on more practical, but still ambitious, reforms such as those agreed for financial regulation was seen as a more pressing priority — while the emerging instability in the Euro Area brought short term crisis

management considerations back to the forefront of the collective agenda. It no doubt contributed to a general growing disillusionment with the G20's ability to deliver tangible outcomes.

A key lesson relates to the need to always be wary of embarking on sweeping reform agendas, without a clear idea of where they may practically lead. This is as true in the domestic sphere as it is in the international, but in the latter one has the added complication of competing sovereign interests and the greater challenges involved in establishing processes that are well designed for building the necessary consensus, both within national stakeholder communities and between national authorities, in a manageable time horizon. Given the unique circumstances that led to the success of the Bretton Woods conference in 1944, one should always be deeply skeptical of calls for a 'New Bretton Woods'. There have been many such rallying cries and none have managed to emulate the success of the original.

For any success in forging an international consensus on even more modest reforms in this area, effective national leadership is crucial. In today's multipolar world, this requires a strong alliance that cuts across the traditional advanced vs. emerging market divide. Moreover, while the US need not be in the vanguard of the push for specific reforms, it must at least not be opposed. The IMS agenda posed potentially fundamental challenges for the US, in terms of the role of the US dollar and the primacy of the Fed Reserve in creating US dollar liquidity, which the US authorities were never going to find palatable. Without US acquiescence, the champions for significant change, in particular Korea and France during their respective years as G20 President, were always going to find these agendas difficult to progress. In the case of an expanded role for the SDR, there was no national champion, only the Fund whose views were seen as compromised by its own institutional bias — even the Chinese position was ambiguous.

As is the case for domestic reform, getting traction for significant change needs a clear consensus that the existing arrangements are sufficiently broken, and clear agreement on the precise nature of the problem being addressed. In this regard, the challenge for progressing IMS reform was as much about reaching agreement on core conceptual issues as it was about brokering a political deal, and on this the broad political weight and ownership which the G20 could muster offered no particular comparative advantage relative to the more technocratically driven governing structures of the IMF and IMFC. Moreover, this challenge is greatly compounded in the international arena, where key players bring to the table widely varying experiences, and an inherent conservatism often shared by advanced and emerging economies alike. Progress often depends on the ability to build critical alliances around tangible and practical outcomes which at best resonate positively with domestic constituencies or at least are not seen as threatening domestic

interests. In the case of the IMS, insufficient thought was given by the proponents to identifying realistically achievable outcomes around which the agenda could be shaped, and which could then form the basis of claimed success and sustained momentum. This inevitably involves an extensive investment of time and energy in building relationships and identifying common ground — and in particular, an openness to understanding and facilitating the domestic priorities and constraints confronting other key players — well in advance of bedding down a concrete agenda.

In practice, given the challenges involved, the ‘norm’ for international governance is more often than not progress by way of small compromises, in which agreement on overall objectives is vague and tenuous at best and the primary driving force is the concern to be seen to deliver something. Significant elements of the narrative on strengthening the Global Financial Safety Net fit with this pattern. The result is a messy process, as the international community edges

imperfectly towards a collective view of overall objectives and acceptable trade-offs, building on the legacy of previous second or third best compromises.

SURVEILLANCE AND POLICY COORDINATION

As the consideration of the IMS agenda ran its course, it quickly became clear that a core area in which one could envisage scope for practical and tangible improvement was that of the role of surveillance in enhancing the adjustment mechanism regarding unsustainable external imbalances. Fund surveillance of members' policy settings is central to the discipline which the crafters of the Second Amendment to the Fund's Articles of Agreement, ushering in a world of greater exchange rate flexibility, sought to bring to bear in support of preserving stability in the post-Bretton Woods era. Concerns about its effectiveness are not new and over the years there have been repeated efforts to improve both the quality of surveillance and its traction with Fund members — that is, the

extent to which Fund advice has a positive influence on members' policy settings and contributes to global monetary stability. A core concern has been the sense that Fund surveillance is inevitably less effective in influencing policy settings in those members considered unlikely to ever need to draw on Fund financial support, hitherto assumed to be the advanced country members. The last few years has, however, been notable for parallel efforts within the G20 to build a country driven, and owned, process of policy coordination — the Mutual Assessment Process (MAP) — based around principles of peer review and accountability.

The theoretical literature on policy coordination generally distinguishes between rules based approaches, such as Fund Surveillance and the WTO's oversight of the international trade system, and discretionary policy coordination, which may range from unilateral policy adjustments based on information sharing, through to formal arrangements entered into by participating governments,

involving binding collective decision making.¹⁵⁷ The experience therefore offers an opportunity to compare efforts to strengthen the Fund's 'rules based' approach with the voluntary, discretionary approach to policy coordination embodied in the MAP.

Fund Surveillance – An attempt at a 'rules-based' approach

Box IV-2 summarizes the 'legal' framework within which the Fund undertakes surveillance of members' economic policies in the interests of preserving the stability of the international monetary system.

As discussed in an earlier section, while 'rules based', Fund surveillance is best characterized as relying on a mix of 'soft' law and moral suasion. Moreover, the precedence given to domestic economic stability, as noted in Box IV-2, is clearly consistent with the primacy of domestic sovereignty.

Moreover, sanctions available to the Fund, in the event of a breach

of obligations by a member, are essentially limited to steps that lead to ineligibility to use the Fund's resources, loss of voting rights and, ultimately, withdrawal of membership. Other than in the case of a small group of members who have fallen into arrears on their obligations to the Fund, these sanctions have never been used, and obtaining the necessary consensus to trigger such censure in future cases of breaches of either Articles IV or VIII would be likely to be highly contentious and problematic.

In practice, Fund surveillance has also come to have a variety of manifestations. Under the broad umbrella of surveillance, the Fund undertakes a number of activities — monitoring economic trends, analyzing developments at the national, regional and global level, offering de facto technical assistance and policy advice, all the way through to attempts at formal policy coordination. An external evaluation of Fund surveillance in 1999 identified six broad areas of

157 See e.g. R.D. Putnam and C.F. Henning, "The Bonn Summit 1978: A Case Study in Coordination", in R. N. Cooper et al, *Can Nations Cooperate?* (The Brookings Institution, Washington DC, 1979)

activity carried out by the Fund in the context of its surveillance role.¹⁵⁸

A certain ambiguity about what precisely surveillance means in practice also arguably contributes to a degree of subconscious confusion within the Fund as to how best to position itself in relations with its members. Recent evaluations by the Fund's Independent Evaluation Office (IEO)¹⁵⁹ have consistently pointed to the contribution of deep seated institutional cultural issues in explaining shortcomings in the Fund's effectiveness. In essence, there is an inherent tension between what one may think of as the Fund's desire to be a trusted policy advisor to member countries while also being the steward of international monetary stability, effectively policing 'legal' obligations, albeit soft ones. The very term 'surveillance' points more to the policing end of this spectrum than to the trusted

policy advisor end. In practice, the Fund has to position itself at differing points along the spectrum between the two, depending on the specific circumstances in each case, but this balance has too often appeared to be determined by default rather than as a result of a considered strategic choice. A tendency, when recruiting and promoting staff to favor technical skills over policy advising skills — by which the author means the set of skills needed to understand the policy making dynamics and political environment in member countries and to craft and pitch the Fund's message in ways most likely to help key decision makers actually deliver improved policy — has compounded the challenge of managing this tension, although one should acknowledge that the current management team led by Managing Director Lagarde has acknowledged the problem and is attempting to address it.¹⁶⁰ Moreover, as the IEO's recent

158 J. Crow, R. Arriazu, & N Thygesen, *External Evaluation of IMF Surveillance: Report by a Group of Independent Experts*, (IMF, 1999), page 17. This report's list contains the following activities: policy advice; policy coordination and co-operation; information gathering and dissemination; technical assistance and aid; identification of vulnerabilities; and delivering the message to national authorities and other stakeholders.

159 E.G. Independent Evaluation Office, *IMF Interactions with Member countries*, (IMF, 2009) and IEO, *IMF Performance in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004-07*, (IMF, 2011).

Box IV-2: Fund Surveillance – the Legal Framework

Articles IV Section 3 , of the Fund’s Articles of Agreement first requires the Fund to “oversee the international monetary system”; and to “exercise firm surveillance over the exchange rate policies of members... [and] ...adopt specific principles for the guidance of all members with respect to those policies”. Article VIII, Section 7 requires Fund members to collaborate with the Fund and others to ensure that reserve asset policies are consistent with the “.objective of promoting better international surveillance of international liquidity..”

Members’ obligations under Article IV are generally expressed in aspirational or ‘best endeavors’ terms, with the exception of a clear requirement to “avoid manipulating exchange rates”. In the context of the Executive Board’s 2012 Integrated Surveillance Decision, manipulation is defined in terms of seeking to prevent effective balance of payments adjustment or gain an unfair competitive advantage. Moreover, a member’s obligation to enhance the stability of the overall exchange rate system is constrained by the recognition that domestic stability should take precedence. That is, so long as domestic policy settings are contributing to domestic stability, a member is under no obligation to adjust these policies in the interest of external systemic stability.

Article IV also gives the Fund the power to require members to consult with it on their exchange rate policies.

Article IV also lays the basis for the Fund’s multilateral surveillance obligations, that is surveillance of the system as a whole as opposed to surveillance of individual members’ policies (generally referred to as bilateral surveillance). This is limited to a reference to the Fund’s obligation to “oversee the international monetary system in order to ensure its effective operation”. There is no further elaboration in the Articles on what this means in practice.

The 'International Monetary System' is a significantly narrower concept than that of the international financial system. It is considered to consist of four elements: rules governing exchange arrangements between countries and exchange rates; rules governing payments and transfers for current transactions between countries; the regulation of international capital movements; and arrangements regarding reserves and official access to international liquidity.

The Executive Board has scope to clarify and elaborate on the application of these obligations, by way of Executive Board decisions, but the underlying obligations of members cannot be added to or amended with a change to the Articles of Agreement.

evaluation, *The Role of the Fund as a Trusted Advisor*, makes clear, the interplay between the trusted advisor and global custodian role is a complex one.¹⁶¹ Preserving the trust of the collective international community, necessary for the latter, requires consistency and evenhandedness in its surveillance activities — and being seen to be both.

These ambiguities and tensions are also echoed at the level of the Executive Board. A Board discussion of the Staff's Report, known as the Article IV report, generally concludes the Fund's bilateral surveillance consultations, although increasingly there is scope for Staff reports to be circulated but only discussed by the Board if a Director so requests (referred to as consideration by the Board on a 'Lapse of Time' (LoT) basis). At the conceptual level, the

Board discussion (or approval on a LoT basis) transforms the report from a statement of the views of Fund staff into the collective view of the international community. In practical terms, the value of the Board discussion is unclear. Directors circulate prepared comments before the meeting, often saying little more than affirming selected messages from the Staff Report. Actual exchanges of views at the Board are limited in most cases. On major systemically important economies, the discussion is more likely to highlight issues on which Directors want to refine or contest the message being delivered by Staff, or the authorities, but it is still the case that there is more often than not a proforma feel to these discussions, and a sense of participants merely going through the motions. It was notable that, while the current MD invests time in attending these discussions

160 During his time on the Fund's Executive Board, the author often suggested that the Fund was a little too inclined to think of itself like an independent Central Bank, which generally enjoys a fair degree of policy autonomy not available to the Fund, and not enough like a Finance Ministry/Treasury which needs to get the attention of its Minister and persuade him or her to act on its advice. In her time as MD, Christine Lagarde has shown significantly more interest in the internal workings of the Fund, its culture and values, than have many of her recent predecessors. This may well reflect her experience in managing a major private sector legal firm, before joining French President Sarkozy's Cabinet.

161 Independent Evaluation Office, *The Role of the IMF As Trusted Advisor*, (IMF, 2013)

rather than delegating chairing the Board to one of her deputies, her predecessor was notably absent for most Board Article IV discussions, even those for major G20 countries, during the author's time on the Board.

While the term surveillance may be meant to imply something more than peer review, this is clearly intended as an important element of the process. In theory, the Board discussion offers such an opportunity. In practice, however, it is rare for the Board discussion to bring fresh perspectives or insights to the policy debate. It has been more common in the author's experience for Directors to view the Board discussion as an opportunity to bring some discipline to bear on the Staff assessment. Looked at in a positive sense, it is a means to encourage evenhandedness. But it also acts to discourage Staff from testing the bounds of the consensus (lowest common denominator) view among the membership on specific policy trade-offs and

options. In this context, Directors' comments are often informed primarily by the desire to influence policy recommendations that may be made in future cases regarding their own countries. (Some have described this as peer protection replacing peer review.)¹⁶²

As noted, concerns regarding the effectiveness of the Fund's surveillance are not new. The 1999 external evaluation noted a number of concerns including reservations regarding the quality of the Fund's analysis of capital account issues, questioned whether the Fund was attempting to expand the scope and coverage of bilateral surveillance too broadly into areas of (non-financial) structural policy, criticized the inadequate treatment of the cross-border impacts of domestic policy settings, alluded to concerns that the Fund's advice was not sufficiently frank and direct, highlighted a number of internal organizational (e.g. silos) and management issues (e.g. excessive and time consuming review processes) that had the po-

162 J. Crow, R. Arriazu, & N Thygesen, Op.cit, page 34

tential to undermine effectiveness, and questioned the value of the Executive Board's involvement.¹⁶³ The IEO's 2006 evaluation of the Fund's multilateral surveillance¹⁶⁴ noted that, while the main vehicles for this — the Fund's twice yearly World Economic Outlook (WEO) and Global Financial Stability (GFSR) reports — were well regarded, this work was not effectively used to help shape the Fund's bilateral discussions on policy options and trade-offs. The sheer size and density of the reports themselves discouraged easy assimilation by key policy decision makers, while there was scope to better integrate the two processes to provide an overall set of targeted policy messages.¹⁶⁵

Recommendations were made by the IEO with an eye to strengthening the Board's, and the IMFC's, ownership of the key messages and a strengthened focus on spillover effects of national policies.¹⁶⁶ Concerns about integration of the WEO and GFSR reflected a growing concern more generally about the Fund's capacity and focus on incorporating financial sector developments and vulnerabilities into its traditionally macro-economic targeted surveillance.

Similar themes are repeated through a number of subsequent IEO evaluations, most recently the 2011 evaluation, *IMF Performance in the Run-Up to the Financial and Economic Crisis*;

163 Ibid, pages 13-14

164 Independent Evaluation Office, *An Evaluation of the IMF's Multilateral Surveillance*, (IMF, 2006)

165 Notwithstanding subsequent support from key voices on the Board (including the US) for a consolidated WEO/GFSR product, progress on this front has been slow. Resistance largely reflects to the concerns of the two responsible Fund Departments – Research and the Monetary and Capital Markets Department – to preserve their separate ownership of the two products. Over recent years, some progress has been made in terms of aligning Board discussions of the two on the same day, some movement towards joint presentations by the Fund's Economic and Financial Counselors, and the preparation of a separate short document that attempts to consolidate the key messages for the IMFC.

166 The Executive Board discusses the WEO and GFSR but, as in the case of Article IV reports, they are considered staff reports. While the Staff may choose to take Executive Directors' comments into account in revising the two reports, it is not obliged to do so.

IMF Surveillance in 2004-07.

Interestingly, this latter report explicitly tackles the question of whether political interference had resulted in surveillance messages being toned down, to the detriment of effectiveness and evenhandedness. It concludes that, while there were instances of strong resistance to some messages from some large advanced economies — although notably, not from the US — the bigger and more subtle issue was that of intellectual capture and group think.¹⁶⁷ Fund staff found it hard to contemplate the possibility that financial regulators and supervisors in advanced economies could get it wrong. The 2007 IEO report, *IMF Exchange Rate Policy Advice*, highlighted the core issue of lack of clarity, both within the Fund and among the membership, regarding the rules of the game on the issue at the center of the Fund's surveillance role.¹⁶⁸

It is also arguable that the process of Fund surveillance has a tendency to be too inward looking. The

tension referred to earlier between the Fund as trusted policy advisor and the Fund as custodian of international stability also manifests itself in ambiguity as to who is the client to whom the Fund addresses its advice? Is the Fund primarily focused on how best to strengthen the arm of policy makers in the country concerned to pursue good policy, or are its reports targeted at the other 187 Fund members? The former requires a high degree of political savvy and sensitivity, and a degree of compromise; the latter less so. Moreover, the latter implies that the principle audience for the Fund's reports is, in the first instance, the Executive Board. The weaknesses in the Fund's internal governance, so well described in the IEO's 2008 report on this issue referred to in Section II,¹⁶⁹ underscores the problems inherent in a set of implicit incentives for Fund staff which suggests that ensuring a smooth Board discussion is more important than shaping outcomes in the country being reviewed.

¹⁶⁷ Independent Evaluation Office, *IMF Performance in the Run-Up to the Financial and Economic Crisis; IMF Surveillance in 2004-07*, (IMF, 2011), pp 17-20

¹⁶⁸ Independent Evaluation Office, *IMF Exchange Rate Policy Advice*, (IMF, 2007), pp 35-36

Academic and other commentary had similarly consistently underscored the weaknesses in Fund surveillance. Proposals have generally involved strengthening the rules and putting more teeth into their enforcement. Such ideas have ranged from increasing transparency and hence public pressure and accountability for policy change, along with greater specificity by the Fund in its policy recommendations, through the issuance of Fund ‘ratings’ and scorecards for member economies,¹⁷⁰ to amendments to the Articles to toughen members’ obligations and the establishment of policy and exchange rate ‘norms’ which, if breached, would trigger appropriately graduated sanctions.¹⁷¹ The WTO’s Dispute Settlement arrangements have been highlighted by some as a model for the Fund to emulate on exchange rate disputes.¹⁷²

Efforts to Enhance Fund Surveillance — the Pre-2008 Track Record

On the eve of the crisis, the Fund was managing the legacy of several initiatives over recent years aimed at updating the framework for surveillance and enhancing traction. Among these were two which had sought directly to clarify and strengthen the system of rules embodied in the Fund’s Articles of Agreement — viz, a proposal to amend the Articles regarding the Fund’s role and powers with regard to capital flows, and a subsequent review of the 1977 Board decision setting out in more detail the framework to be applied for bilateral surveillance, leading to a new 2007 Surveillance Decision. In both cases, the challenge of codifying arrangements in the absence of a genuine underlying international consensus proved problematic. It had also experimented with the use of its powers under the Articles to require members to

169 Independent Evaluation Office, *Governance of the IMF*, (IMF 2008)

170 E.G. See Edwin M. Truman “Overview on IMF Reform” in Edwin M. Truman, ed. *Op.cit.*, pp55-56_

171 This is a core proposal of the Palais Royale Initiative. See Jack T. Boorman and Andre lcard, eds. *Op.cit.*, pp 14-18

172 Paul Blustein, *Op.cit*

consult with it on their exchange rate policies, by engaging selected systemically important members in multilateral consultations on the issue of global imbalances — that is, the longstanding concern that domestic policy settings in systemically important economies were producing excessive consumption in some economies (e.g. the US), matched by excessive savings in others (e.g. China), and mirrored in unsustainable external deficit and surplus positions.

The amendment to the Articles, pressed by Fund management through the latter half of the 1990s, involved endorsement of capital account liberalization among the Fund's overriding objectives, and incorporation of jurisdiction over policies relating to capital flows into Article IV, with a view to effectively reverse the existing presumption under the Articles that capital controls were allowed unless otherwise specified. Section II has already highlighted the extent to which the dramatic growth in private capital flows had tested the intellectual framework which had guided the original

drafters of the Fund's Articles, and contributed to the demise of the Bretton Woods system. These proposals ultimately foundered on the growing disillusionment with untrammelled capital liberalization in the aftermath of the 1997-98 Asian financial crisis, amid criticism that the Fund had been too zealous in adopting a liberalization agenda even without the legal basis for such. Interestingly, outside of Fund Management, support had been strongest among European Executive Directors concerned that jurisdiction over capital flows would otherwise migrate to the WTO's then newly established dispute settlement arrangements. US support had at best been lukewarm, and collapsed in the face of a backlash from Congress. Other G7 members were opposed along with emerging market and developing country Directors, while Wall Street was ironically most focused on the perceived dangers of the Fund legitimizing those capital controls it might chose to approve.^{173, 174}

The subsequent shift in focus, to attempts to clarify the existing

legal position, reflected in large part pressure from the US keen to multilateralize its dispute with China regarding the dollar - renmimbi bilateral exchange rate. Paul Blustein has colorfully detailed the forces and machinations which shaped this process.¹⁷⁵ Both the process of reaching agreement on the June 2007 Decision, and its implementation, proved deeply divisive, both within the Fund and between members, and disruptive to the bilateral surveillance process. The new decision, concerned solely with bilateral surveillance, introduced the concept of external stability, defined as a situation in which a country's underlying current account is considered consistent with the absence of risk of 'disruptive movements in exchange rates'. Under pressure from the US, it also introduced a requirement on Fund Staff to formally, and publicly, judge whether a country's exchange rate was 'fundamentally misaligned'. Indeed, the US authorities was adamant in the Fund Board, in meetings with Fund management

and staff, and in bilateral meetings with other Fund members, that progress on the new decision was crucial to their ability to ensure continuing US support for the Fund which was at that time seeking agreement to the second stage of the quota package agreed in Singapore.

Inter alia, the decision represented an attempt by Fund staff to test the limits of the primacy given to domestic stability considerations under the Articles, and to allow for a broad interpretation of the extent to which domestic policy settings could contribute to a fundamental misalignment of exchange rates and external instability. In the event, as Blustein documents, apparent inconsistencies and confusion in its subsequent application — fueled variously by drafting compromises required to reach agreement, differing interpretations and agendas among Staff and Management, and the difficult politics of managing relations with key members¹⁷⁶ — quickly eroded perceptions of evenhandedness,

173 Rawi Abdelal, "The IMF and the Capital Account", in Edwin M. Truman, ed. Op.cit, Chapter 8.

174 The OECD's attempt, over the same period, to negotiate a Multilateral Agreement on Investment, was equally unsuccessful.

175 Paul Blustein, Op.cit

while the ‘fundamentally misaligned’ label came to be seen, albeit unintended by the drafters of the Decision, as a euphemism for exchange rate manipulation and therefore an implied breach of the Articles. The Fund’s methodology for determining the sustainability of a country’s external position also attracted significant criticism, highlighting the uncertainties involved in many of the underlying assumptions required.

The fragile consensus in support of the Decision quickly eroded. Chinese resistance to a likely declaration of fundamental exchange rate misalignment resulted in a three year hiatus in the conclusion of an Article IV consultation with the Fund, while consultations with a handful of other similarly situated countries were also delayed. By the end of 2008, the onset of the financial crisis was to dramatically displace the US authorities preoccupation with the issue of

the Chinese exchange rate, and the impasse between China and the Fund was finally resolved in 2009 when the Fund’s new MD, Strauss-Kahn, adjusted the internal implementation guidance, removing the obligation on Staff to formally make such a judgment.¹⁷⁷

The Fund’s initiative in 2006 to convene multilateral consultations with selected members on global imbalances represented an alternative approach, drawing on its existing powers and the hope that such consultations might engender ‘buy in’ from the key players to a cooperative solution. The consultations, with the US, China, the Euro Area, Japan and Saudi Arabia, was the first attempt to use the Fund’s power, under Section 3 of Article IV, to require members to consult with the Fund on their exchange rate policies. It was an ambitious experiment. Unfortunately, the initiative failed to attract the direct engagement

176 Blustein highlights the debate within Fund staff and with the US authorities as to whether the US dollar and Japanese Yen, alongside the Chinese renmimbi, should have been judged ‘fundamentally misaligned’, and also notes the significance of the abrupt departure of Fund MD de Rato, a champion of the Decision, his replacement by Dominique Straus-Kahn in late 2007, as a key personnel change that affected the institution’s ownership of the Decision and approach to its implementation.

177 As this was an operational issue, the MD did not require Board approval for this decision.

of Ministers — the meetings took place at Deputies level — and the five participants proved reluctant to commit to any new policy initiatives beyond those already announced as part of their respective established domestic policy agendas. In the time honored tradition of such international initiatives, the consultations were declared a (modest) success,¹⁷⁸ and not subsequently repeated.

A key issue in assessing what could have been done to get more out of the multilateral consultations relates to the Fund's difficulty in positioning itself in these consultations: should it have played an active role, leading the discussions and seeking to guide the outcomes, possibly even monitoring progress against whatever undertakings national authorities had been prepared to make? Or should it have looked to foster the ownership of the participants, by stepping back and

looking to be merely the facilitator of the discussions? External commentators are inclined to lean in favor of the former.¹⁷⁹ However, there is no basis to assume that national authorities, especially those of large systemically important economies, would be willing to expose themselves to the likelihood of domestic criticism that they were ceding sovereignty over domestic policy without being able to demonstrate that they retained control of a process which would produce outcomes in their long term national interest.

Against the backdrop of this experience, the discussion of surveillance issues at the October 2008 IMFC meeting had eschewed calls for new approaches, but rather endorsed, for the first time, a Statement of Surveillance Priorities,^{180, 181} setting out a concise list of economic and operational objectives for the coming three year period. The former focused

178 See International Monetary Fund, *Staff Report on the Multilateral Consultation on Global Imbalances with China, the Euro Area, Japan, Saudi Arabia, and the United States*, (IMF, June 2007), which concluded that "Overall, the first multilateral consultation helped bring about a better understanding among the participants of the issues and of each others' positions, and culminated with the publication of policy plans by each participant which when implemented could significantly reduce global risks." Paragraph 6 of the Executive Summary.

179 E.G. Paul Blustein, *Op.cit.* page 26

on encouraging consistency and cooperation in national policies in four key areas — resolving financial market distress, strengthening the global financial system, adjustments to sharp changes in commodity prices, and global imbalances — while highlighting the need for enhanced risk assessment, improved financial sector surveillance and its integration into the Fund’s traditional mainstream focus on macroeconomic stability, a stronger focus on cross-border spillover implications, and on exchange rates and external stability as the core operational objectives.

Post-Crisis Efforts to Reform Fund Surveillance — Evolution Vs. Revolution

Encouraged by the G20 to strengthen surveillance, many of the Fund’s efforts since the onset of the crisis has been focused on the development of new processes and products to deepen the analysis of both domestic and cross border developments, better

identify systemic risks (including by more effectively ‘joining the dots’), and experimenting with new means of delivering key messages and engaging national policy makers.

In direct response to a call by G20 Leaders’ in their 2008 Washington Declaration, the Fund initiated a regular Early Warning Exercise (EWE), in collaboration with the FSF/FSB, the results of which are presented to the IMFC in a restricted session at each biannual meeting. A pragmatic response to early unrealistic demands for a systemic approach to identifying future crises,¹⁸² the EWE attempts to provide IMFC members with a confidential, and therefore candid and blunt analysis of potential tail risks which may not be easily identified in mainstream — and public — surveillance documents. It is also a device to foster closer collaboration between the Fund and the FSB on financial vulnerabilities. Critics have pointed out that progress on the latter has

180 See *Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund*, October 11, 2008, Annex

181 As an aside on governance sensitivities, considerable reluctance had been expressed by some Executive Directors regarding the IMFC’s role, as an advisory body only, in endorsing these priorities and calling for regular reports on monitoring their implementation.

been limited, and the challenge of identifying genuine tail risks from those that are more central to the current continuing fragile situation in the Euro area and elsewhere remains difficult.¹⁸³ Nonetheless, the EWE does provide a valuable opportunity for engaging policy makers in a more confronting discussion of risks than would be possible in a more open setting, and has been the catalysts for extending the Fund's analysis of vulnerabilities, previously limited to those in emerging economies, to advanced member countries.

A renewed focus was placed on enhancing the effectiveness of the Financial Stability Assessment Program (FSAP) assessments of the quality of members' financial regulation, compliance with agreed international standards and risk vulnerabilities under the had been introduced on a voluntary basis following the Asian financial crisis. However, the effective implementation of this had long faced a number of difficulties.

The assessments (carried out

jointly with the World Bank in the case of developing and emerging market economies) were hugely resource intensive, cumbersome and time-consuming, took place infrequently, and struggled to balance a focus on compliance with standards with the timely identification of systemic risks. Integration of the financial stability considerations into the more regular Article IV consultations was too often stymied by the challenge of ensuring the Article IV teams contained the right skill sets, and a silo mentality within the Fund which constrained communication and cooperation between the relevant Fund Departments. The institutional resistance to integrating the key messages from the regular WEO and GFSR exercises, referred to earlier, reflected deeper seated problems. And the challenge of addressing these problems had also been compounded by the need to also deliver the budget and staffing cuts agreed as part of the 2009-11 restructuring package.

The US and China, notable at

182 The decision to label this process an 'exercise' rather than a 'system' was a deliberate choice to avoid the impression that all future risks and crises could be predicted.

183 See, e.g. S. Brooks, W. Clarke, M. Cockburn, D. Lanz, and B. Momani, *Coordination Critical to Ensuring the Early Warning Exercise is Effective*, CIGI Policy Brief No 4, April 2013 (Center for International Governance Innovation)

the start of the crisis for not having consented to an FSAP assessment, agreed to do so as part of a collective G20 commitment, and the Fund Board subsequently agreed, in 2010, to mandate such assessments for the 25 members judged to have systemically important financial centers. This agreement had to overcome resistance from some EMEs who preferred the Fund to focus on financial vulnerabilities in the advanced economies, and a degree of general skepticism, given the sense that, despite efforts at reform, FSAP assessments remained cumbersome and mechanistic. (The latter translated into agreement on a five year cycle, rather than the three year period initially proposed by Fund Staff.) Arguably more importantly, various reforms have been made to the FSAP, to improve the analysis, sharpen the focus and ensure a more systematic risk based approach, and efforts have also been made to introduce greater flexibility into the FSAP process.¹⁸⁴ The Fund,

with endorsement from the G20, has also embarked on a program to improve access to the data considered necessary to monitor interconnectedness, although it continues to face resistance from national authorities to provide data on individual financial entities. (There is also some lingering suspicion that it aspires to the role of global macro-prudential regulator, something for which there is no consensus.) Meanwhile, the task of tackling the Fund's internal silos and integrating the work of specialist Departments such as the Monetary and Capital Markets Department more effectively into that of the Area Departments continues, with some signs of success — certainly, recent Article IV reports for systemically important economies have had consistently greater focus on financial stability issues.

There have been other innovations. In 2009, the Fund introduced a regular new biannual report, *The Fiscal Monitor*, which grew out of the demand for an overarching

184 See, e.g. International Monetary Fund, *Financial Sector and Bilateral Surveillance — Towards Further integration*, (IMF, August, 2009)

framework for calibrating advice on the withdrawal of stimulus policies put in place at the height of the crisis — together with, one suspects, the Fiscal Affairs Department's ambitions to have a standalone flagship product. In the context of discussions through the course of 2010 on options for modernizing surveillance, the Fund decided to experiment with the production of 'Spillover reports' for China, the Euro Area, Japan, the UK and the US — the 'systemic five'. (In the light of the legal constraints on bilateral surveillance under Article IV, these exercises take place under the Fund's multilateral surveillance authority, under which members' obligations are limited to having to agree to consult with the Fund. A consolidated report summarizing the outward spillover analysis for each which draws on the Fund's analysis, and consultations with both the jurisdiction concerned and those subject to the spillover effect, was issued in each of 2011 and 2012. The agreement of the five jurisdictions to participate was only achieved on the basis of

extensive negotiations to set the ground rules for the exercise, especially the discussions with third parties, and to ensure a common approach in each case.) In July 2012, the Fund released a pilot External Sector Report, an attempt to place the issue of exchange rates in the wider context of the broad range of domestic policies, both in the country concerned and in other countries, which may have an impact on external balance, while addressing criticisms of the Fund's earlier analytical framework for assessing the sustainability of a member's external position. The US had pressed the case for such a report, again drawing on the Fund's multilateral surveillance authority, to re-focus attention on a core aspect of the Fund's surveillance responsibilities, given the erosion of confidence in the 2007 surveillance decision described earlier. Notwithstanding a range of concerns, largely relating to the difficulties of accommodating country specific considerations into an analytical framework which requires a large number of assumptions to try to bring con-

sistency to the judgments made about each of the twenty-nine countries included, Directors acquiesced in its development albeit while withholding the sensitive individual country assessments from publication, and cautioning against rushing too quickly to policy recommendations on the strength of the pilot analysis.

These initiatives were progressed in the context of the Fund's latest Triennial Review of Surveillance,¹⁸⁵ conducted through the course of 2011, which included a number of other modest but pragmatic steps to strengthen surveillance, and in particular its traction with decision makers. It is worth noting some of the ideas that emerged through the course of this process and the earlier Board discussions on modernizing Fund surveillance which were not pursued. There was little appetite to rekindle the idea of multilateral consultations. Nor was there any great enthusiasm for proposals to more formally link the outcome of surveillance processes to eligibility for access to Fund

resources or to facilitate a more active role for the IMFC in the peer review of members' policies. The former would have been seen as too confronting in terms of the Fund's constructive relations with its sovereign members, while the latter threatened to re-open wounds regarding the relative role of the Board vs. the IMFC. Overall, radical change has largely been eschewed in favor of practical refinements — as one member of the Board observed, the Fund is much more comfortable pursuing evolution than revolution.

This evolutionary approach has not, however, restricted the Fund from also revisiting the scope for tackling some fundamental issues regarding the underlying framework for surveillance. In this context, two initiatives during this period are especially noteworthy. One relates to the Fund staff's recent efforts to revisit the issue of the Fund's views and advice on capital flows. The other is the 2012 agreement on a new Integrated Surveillance Decision (ISD).

185 International Monetary Fund, *2011 Triennial Surveillance Review – Overview Paper*, (IMF, August 2011)

Re-visiting the Fund's role regarding capital flows

As already noted, the capital flows issue was a central plank of the G20 discussions on reform of the IMS through 2010-11. The sensitivities apparent through that process did not discourage Fund staff and Management from aspiring to bring greater structure and predictability to the Fund's surveillance role in this area. There was a strong view from Staff that the late 1990s failure to reach agreement on proposed amendments to the Articles, together with the reaction to criticism that the Fund had been excessively pro-capital account liberalization, had compromised the Fund's ability to respond to the substantially increased systemic role played by global capital flows — an area in which Staff bemoaned the fact that there were no established 'rules of the game.'¹⁸⁶ As a long term option, Staff again put forward the idea of amending the Articles: if consensus on the earlier pro-liberalization proposals remained unachievable, Staff suggested a more 'neutral'

approach of incorporating a commitment for members to collaborate with the Fund to ensure that '...international capital movements support both sustainable economic growth and the stability of the IMS'.¹⁸⁷ Staff aspired to bring some hierarchical structure to what they considered a patchwork of other international commitments and obligations regarding capital flows, in particular those required of members of the OECD and the WTO, no doubt with a central and overarching role for the Fund. However, the immediate focus of Staff's proposals was an extensive work program to strengthen the agreed analytical framework in an effort to bring greater rigor and consistency to Fund policy advice on the appropriate range of national policies to manage the risks and maximize the benefits of cross border capital flows.

This was to take a series of Fund papers and Executive Board discussions over the following two years and result in the release, in December, 2012, of an agreed 'institutional view' on capital

186 International Monetary Fund, *The Fund's Role Regarding Cross Border Capital Flows*, (IMF, November 2010), page 3

187 Ibid page 35

flows.¹⁸⁸ The result is a balanced, empirically based, pragmatic suite of policy observations. It acknowledges both the benefits and costs of capital flows, leans in favor of a measured and carefully calibrated approach to liberalization while stopping short of championing liberalization for all countries in all circumstances, acknowledges the appropriateness in some circumstances of both capital control and macro-prudential measures to contain destabilizing volatility and manage the potential for these to flow through to excessive domestic risk taking, but also notes their limitations and the need to use them as part of a broader, sustainable set of macro-economic and structural policies, and generally eschews doctrinaire or mechanistic approaches. Overall, it is hard to describe the findings and recommendations as other than eminently reasonable. Many external commentators have since applauded what is seen as a commendable shift in the Fund's thinking on these issues.

Nevertheless, obtaining Board

endorsement was a long and labored process.

It was quickly evident, as no doubt Staff had feared, that the necessary support for contemplating amendments to the Articles remained elusive, even when expressed as a 'long term' option. The case for expanding the Fund's legal prerogatives at the expense of national sovereignty is always a hard one to make, and the Fund's 'neutral' option, to build in a requirement that members' policies be supportive of economic growth and the stability of the IMS, did not assuage suspicions that these concepts could still be broadly defined to justify considerable interference in domestic policy choices. Moreover, for almost all members, changes to the Articles require domestic legislation and even among those who acknowledged the case being made by the Fund's Legal department there was an understanding that this would be a difficult and time consuming process, likely to attract extensive domestic debate and requiring considerable invest-

188 International Monetary Fund, *IMF Adopts Institutional View on Capital Flows*, IMF Survey Online, December 3, 2012

ment of political capital to build the necessary domestic consensus in support. Few thought the benefit likely to warrant the domestic political pain and the risk of failure.

Equally, a significant number of EME Directors were deeply suspicious of any talk of policy ‘frameworks’ or ‘guidelines’ as such labels continued to smack of a prescriptive approach. While staff approached this issue with a view that it wanted to take a more flexible, less ideologically driven approach, from the EME perspective the Articles currently did not limit members’ policy options with regard to capital flows, and they were determined to avoid any efforts, *de facto* or *de jure*, that might encroach on that freedom. There was also strong resistance to formulations that implied a mechanistic hierarchy of policy options.

If the EMEs were worried about excessive prescription, the US and some others remained concerned that the Fund’s proposals were too equivocal. However, efforts by the US and a few other advanced

economies to couch the findings in terms of capital controls being acceptable only as a temporary last resort, once all other policy options had been exhausted, were strongly resisted by EME and developing country directors, and by some advanced economies whose recent experience did not support the realism of such neat sequencing. A US concern that the Fund’s analysis had put to one side consideration of policy issues for economies with closed capital accounts — that is, China — was taken up, instead, in the pilot external balance assessment referred to earlier. And it was important, in the context of EME concerns regarding the spillover effects of unconventional monetary policy easing in advanced economies, that the Fund’s findings gave equal weight to policy issues in both capital source and destination economies.

In this context, the agreement reached late last year reflected an acknowledgement that, at the end of the day, the Fund’s ‘institutional view’ on capital flows was no more than operational guidance

— well based and sensibly pragmatic — for Fund staff in their consultations with national authorities, on an area of policy where previously there had been no such guidance. In that sense it was valuable. To the extent that some Board members may have preferred to nuance the policy trade-offs differently, the material implications in terms of the Fund's actual policy advice to members was not likely to be substantial. Most importantly, it brought no new obligations for members. In that regard, it built on the compromise reached a year earlier in the G20, whose 'coherent conclusions' on the management of capital flows were explicitly stated to be '...a non-binding contribution to their decision making processes regarding capital flow management measures, and not [seen] as a limitation of national policy choices.'¹⁸⁹

The 2012 Integrated Surveillance Decision (ISD)

Agreement on the ISD¹⁹⁰ in July 2012 equally depended on a clear understanding that it imposed no new obligations on members. Indeed, the final agreed text of the decision labors this point, alongside repeated references to limits of the Fund's jurisdiction over domestic policy settings, a reflection of last minute drafting refinements needed to ensure unanimous support.

Rather, the revised surveillance decision attempts to lay the foundations for a more integrated approach to bilateral and multilateral surveillance, including clarifying the legal basis for products such as the 'spillover' reports referred to earlier, and introduced prior to the ISD which took effect at the start of 2013. It expands the ambit of relevant spillovers from domestic policy beyond those that operate through the balance of payments (a constraint introduced in the 2007 decision). It seeks to clarify

189 *G20 Coherent Conclusions for the Management of Capital Flows Drawing on Country Experiences*, as endorsed by G20 Finance Ministers and Central bank Governors, October 15, 2011.

190 International Monetary Fund, *Modernizing the Legal Framework for Surveillance – An Integrated Surveillance Decision*, (IMF, July 2017 2012)

the scope of the Fund's multilateral surveillance mandate, and spell out its modalities, including those relating to any future multilateral consultations. But perhaps most importantly, it is an attempt to put to rest the lingering sensitivities and resentments associated with the experience of the 2007 decision by attempting to broaden the focus beyond exchange rate policy, in particular by adding a principle E to the principles set out as guidance of members' policies under Article IV of the Articles. Principle E requires members to 'seek to avoid domestic economic and financial policies that give rise to domestic instability.' The reference to domestic economic and financial policies has helped provide EMEs with a greater degree of comfort that advanced economies such as the US and Europe will be equally targeted by Fund surveillance. (Ironically, a similar draft principle had been dropped from the 2007 decision at the insistence of EMEs concerned at the Fund's potential intrusion into domestic policy sovereignty.)^{191,192}

Not surprisingly, therefore, China had consistently been the strongest exponent of a fix for what it saw as the underlying bias in the 2007 decision. Other members around the Executive Board had been more equivocal in their support. Importantly, many, including both advanced (e.g. the US) and EME Directors (including the remaining BRICs), expressed skepticism as to the extent to which the legal framework underpinning surveillance was central to the issue of traction and effectiveness. The Fund had not been constrained by the existing legal framework in demonstrating considerable flexibility in the development of new products and processes as demands on Fund surveillance evolved through the crisis. If traction was the key concern, argued some EMEs, then energy might better be directed towards governance reform. Questions as to which categories of a member's domestic policies might be subject to the Fund's legal authorities, and under what circumstances, were seen by many as largely

191 Paul Blustein, Op.cit, page 15

192 The 2007 Decision's draft principle E had referred to the avoidance of domestic policies that lead to external instability, in contrast to the ISD's principle E which links domestic policies to potential domestic instability underscoring the primacy given under the Articles to members' domestic stability considerations.

immaterial in terms of the Fund's actual engagement with members. As the ISD itself notes, 'dialogue and persuasion are key pillars of effective surveillance', and several were inclined to argue that the potential value in the ISD depended less on the details of the decision and more on the extent to which it facilitated the political buy-in and ownership of the surveillance process by policy makers in national authorities.

At the end of the day, the Board's broad support for the decision reflected less a concern for filling in and clarifying gaps in the legal framework and more the hope that it offered a potential means of strengthening the political legitimacy of the Fund's surveillance process without imposing any further binding constraints on national sovereignty. It is yet to be seen if that potential value can be fully captured.

To summarize, therefore, the Fund's response to calls for enhanced surveillance in the aftermath of the crisis has been to focus on improving analytical

frameworks, alongside the development of new products and processes. These have been aimed at a more integrated treatment of macroeconomic and financial risks. Moreover, it has sought to embody this more integrated approach in a decision that offers greater clarity and a more politically acceptable presentation of the surveillance approach without any change to the key rules that underpin its (loose) 'rules-based' approach. As noted earlier, over the same period, the G20 embarked on an experiment in discretionary policy cooperation and coordination — the MAP.

The G20's Mutual Assessment Process — an attempt to harness ownership.

The Fund's 'rules based' surveillance clearly struggles with something of an identity crisis, and resolves the operational tensions inherent in the apparent laxity of its rules by focusing, in practice, on the potential for robust, high quality technical analysis, and effective delivery of policy advice, to encourage the needed buy-in by national authorities to shared

policy goals, and an understanding of the policy settings needed to deliver these. In contrast, the evolution of MAP has represented an explicit attempt to foster coordinated collective economic policy action among G20 members, via a process that holds each accountable to the others, and more broadly, for delivering mutually agreed domestic policy commitments. The 'MAP' label was dropped following the recent St Petersburg Summit, reflecting some frustrations with the evolution of the process to that point and an apparent desire by G20 Leaders to focus attention more explicitly on the core objective of policy coordination, namely a collective agreement on compatible national growth strategies. Nonetheless, the essential characteristics of the MAP experiment remain in place, and its continuing evolution, under whatever name, provides an important counterpoint to the experience with Fund surveillance.

It emerged from the Pittsburgh G20 Leaders meeting, seeking to build what many saw as the

success of the Washington and London summits, whose collective endorsement of the need for extraordinary stimulatory measures in the face of the risk posed by the crisis had provided the political cover needed by national authorities to take such measures. (To the extent that the G20 coordination process to that point had actually encouraged some authorities to undertake stimulus measures that may not otherwise been pursued, it had also enhanced their domestic effectiveness by limiting cross border leakages.) In the context of a growing focus on how best to exit from this extraordinary stimulus, Leaders at Pittsburgh called on their Finance Ministers and Central bank Governors '... to launch the new Framework [for Strong, Sustainable and Balanced Growth] by November by initiating a cooperative process of mutual assessment of our policy frameworks and the implications of those frameworks for the pattern and sustainability of global growth.'¹⁹³ It was hoped that the MAP would do more than again provide cover for policies that

governments intended to pursue in any event and have a positive signaling effect for markets, valuable though both those outcomes would be; the MAP's proponents aspired to generating a better overall policy mix as a result of explicit cooperation.

In terms of the spectrum of discretionary policy coordination referred to above, the MAP was to be a voluntary arrangement, driven by and building on the strong ownership of the G20 Leaders. Institutional arrangements and processes were to be agreed between the G20 participants, with scope for their evolution over time as the MAP, it was hoped, deepened and became better established. The lessons from the IMF's underwhelming 2006 Multilateral Consultations were to be taken into account. This was not intended as a one-off exercise, but an evolving process which would provide a unifying discipline on G20 discussions through successive presidencies. The initial structure of the process,

agreed by G20 Finance Ministers and Central Bank Governors at their meeting in St Andrews in late 2009, involved the following five steps: G20 countries would share information on their policy plans and frameworks, together with their national medium term economic forecasts, initially by end January 2010; by April 2010, the IMF would then use this information to develop a 'base case' medium-term projection for the global economy, premised on G20 countries delivering on their planned policy measures;¹⁹⁴ the G20 would then judge whether the medium term projection met the test of producing 'strong, sustainable and balanced growth', identify inconsistencies and potential downside risks and agree whether additional national policy action is necessary to achieve this overarching objective; the Fund and other international institutions may then be called upon to assess the medium term impact of alternative policy scenarios: and the G20 would draw on this analysis to agree an Action Plan for the com-

193 Leaders' Statement, The Pittsburgh Summit, September 24-25, 2009, paragraph 6

194 The World Bank was also asked to assess the implications of G20 policy settings for global poverty

ing period.¹⁹⁵ A working group of G20 officials, co-chaired by Canada and India (following the model of shared advanced/emerging market leadership adopted more generally in the G20), was established to support the process.

As the MAP evolved, it had to deal with a number of practical, conceptual, and political issues.¹⁹⁶ The initial focus on stimulus exit strategies produced the Toronto G20 commitment that advanced economies would half their fiscal deficits by 2013 and stabilize or reduce their public debt to GDP ratios by 2016, as part of a measured country by country approach to unwinding fiscal stimulus while surplus economy sought to shift from external to domestic demand driven growth models, including by promoting greater exchange rate flexibility, and all G20 countries pursued growth enhancing structural reforms.¹⁹⁷ Following Toronto, the focus began to return to the issue of global imbalances, amidst concern that the improvements

witnessed through the crisis were predominantly cyclical (i.e. temporary) in nature. Target ranges for country level current account imbalances (of, for example, plus or minus four percent of GDP) were proposed but rejected as too mechanistic, with a risk of miscommunication to financial markets. Instead, between the Seoul and Cannes summits, countries' external positions were assessed against an elaborate set of indicators, proposed by the Fund, as a (politically neutral)¹⁹⁸ means to identify a sub-set of G20 members experiencing persistently large imbalances who would then be the focus of individual 'Sustainability Reports' produced by the IMF.¹⁹⁹ At the same time, against the background of the worsening Euro Area sovereign debt crisis, the question of the appropriate pace of fiscal consolidation continued to attract considerable attention, alongside a growing focus on intra-Euro Area imbalances and structural and institutional measures needed to

195 Creon Butler, "The G-20 Framework for Strong, Sustainable, and Balanced Growth: Glass Half Empty or Half Full?" in *Oxford Review of Economic Policy*, Volume 28, Number 3, 2012, page 473

196 Ibid, for a general discussion of these.

197 The G20 Toronto Summit Declaration, June 26-27, 2010, Annex 1

restore Euro Area sustainability. At the Los Cabos Summit, this resulted in consideration of a detailed, and reasonably candid, IMF analysis of Euro Area sustainability, together with an updated G20 ‘Growth and Jobs Action Plan’ incorporating additional country policy commitments focused on the Euro Area’s challenges.

Progress was progressively made on a number of key elements of the process. Operational issues regarding the inputs of third parties such as the Fund, FSB, the OECD, ILO etc, were fine-tuned, with efforts to integrate these contributions into a single product wherever possible. A shared understanding of what is meant by strong, sustainable and balanced growth was developed, elaborating on each of these three elements. The importance of strengthening the accountability mechanisms was acknowledged, with the Los Cabos agreement on six principles: the MAP would remain country owned and led; with implementation of com-

mitments subject to a ‘comply or explain’ approach; the use of concrete quantitative yardsticks wherever possible; a consistent and comparable approach across all G20 participants; based on open dialogue, self-assessment and objective third party analysis; and an overall commitment to transparency. In this context, since the Cannes summit, G20 countries have been sufficiently comfortable with the process to accept publication of country specific commitments. And at Los Cabos, selected countries made presentations on the progress in implementing these commitments.²⁰⁰

Nevertheless, it remains the case that countries have demonstrated little interest in making commitments that extend beyond policy actions they would have taken anyway. Also, some have noted that the decision to unbundle the rubric of ‘strong, sustainable and balanced’ growth, and define each element as separate and independent objectives (not necessarily

198 Others close to the process described its value to the author in terms of the “pretence of objectivity”

199 Seven G20 members were identified – China, France, Germany, India, Japan, the UK and the US

the preferred approach for many G20 participants, but an approach championed by some major players) has resulted in a significant expansion in the number and range of detailed commitments made, with consequent implications for monitoring and accountability.²⁰¹ More fundamentally, it must be said that the outcomes in terms of the quality of the recovery from the crisis, were seen by many as disappointing. As noted by Canadian officials involved in supporting the exercise, 'global growth has been neither strong nor balanced.'²⁰²

The experience of earlier attempts at macro-economic policy coordination remains apposite. Most commentators agree that the only historical example of such coordination which appears to have resulted in genuine policy changes by the participating countries was

the 1978 Bonn G7 summit.²⁰³ Putnam and Henning's seminal case study of the Bonn summit suggests that this was largely due to a unique confluence of domestic political forces on the key issues, which allowed the key supportive interest groups to leverage of the international negotiations.²⁰⁴ In contrast, subsequent coordination efforts — the Plaza accord in 1985 and the Louvre Accord in 1987 — serve to highlight the difficulties in delivering policy commitments which are clearly hostage to domestic political forces. In particular, while the monetary policy commitments proved sustainable at least in the short term, the fiscal policy commitments were far more problematic.²⁰⁵ The subsequent two decades saw the machinery of G7 macroeconomic policy coordination limit itself to information exchange, dialogue and high level agreement on broad

200 Creon Butler, Op.cit, (2012) page 486

201 Hamid Faruqee and Krishna Srinivasan, *G-20 Mutual Assessment Process – A Perspective from IMF Staff*, (IMF, 2012)

202 Robert Levine and Subrata Sarker, "The G-20 Framework for Strong, Sustainable and Balanced Growth: Macroeconomic Coordination Since the Crisis," in *Bank of Canada Review* Winter, 2012-2013, page 5

203 Ralph C Bryant and Edith Hodgkinson, "Problems of International Cooperation," in Richard N. Cooper , Op.cit, page 2

204 Putnam and Henning, Op.cit.

policy directions and goals.²⁰⁶ One can only predict that, as the G20 owned process increasingly incorporates structural policy issues, participants' capacity to stretch the limits of domestic acceptability will be further tested.

Nevertheless, the G20 process has continued to enjoy the ownership of its participants, an intangible strength that remains elusive in other forums such as the IMFC and which continues to underpin its potential to add genuine value. Moreover, the process has other strengths. This is arguably most evident in the handling of the politically sensitive issue of persistent external imbalances. US concerns regarding the Chinese exchange rate have been a constant and key part of the sub-text to the MAP, as the US looked to alternative ways to pursue its concerns in the wake of the failure of the Fund Surveillance to demonstrate traction on this issue. It must be stressed that, behind the posturing and argument on this issue, the Chinese authorities fully

appreciate that, in due course, the Renmimbi has to appreciate in real terms as a central part of the required long term switch from external to domestic demand driven growth. The issue is in part one of timing, to manage the inevitable domestic adjustment pressures, and in part one of not being seen to be dictated to by outsiders. The recourse to development of complex 'indicators' referred to earlier as means of identifying those G20 members warranting additional sustainability analysis was criticized by some as an elaborate and unnecessary distraction, given that the seven countries subsequently selected were the obvious candidates. There is no doubt that the process, which took the best part of 2011, was little more than a fig leaf to avoid the political sensitivities involved in being singled out as a country with a persistent imbalance. The indicators were largely designed to ensure the process selected the key systemically important countries with imbalances, and the

205 Lawrence H. Meyer, Brian M. Doyle, Joseph E. Gagnon, and Dale W. Henderson, "International Coordination of Macroeconomic Policies" in Vines and Gilbert, ed. *Op.cit.* (2004)

206 M. Sobel and L. Stedman, *Op.Cit.* (2006)

resulting list was very predictable. Moreover, the Chinese authorities resisted any inclusion of indicators it considered sensitive, such as the current account position (although its individual components were included), or reserves accumulation. But herein lies one of the G20 driven processes' potential strengths, namely the capacity to handle such political sensitivities in a multilateral setting and behind a veil of technical objectivity, allowing dialogue to continue and buying time to allow the more fundamental consensus needed to emerge.

In this context, it is worth briefly exploring the evolving interface between the MAP and its more recent incarnation, and the Fund, including in particular the role of the Executive Board. The Fund's independent technical input has been crucial to the quality of the dialogue in the MAP and improvements under way in areas of Fund surveillance, such as spillover analysis and the external balance assessment methodology, offer the potential to significantly further enhance the process. For its, part,

Fund Management and Staff were keen to support the MAP and in so doing, strengthen the impact of the Fund's surveillance work and consolidate the institution's relevance. However, protecting the G20 'ownership' of the process remained an overarching constraint and the Fund's input has therefore been provided under the guise of technical assistance. This may seem a technical distinction, but it is crucially important because it significantly minimizes the role of the Executive Board in vetting any of the material provided by the Fund to the G20.²⁰⁷

Clearly, G20 efforts at policy coordination remains a work in progress. Some who have been involved speak positively of the progress made in establishing processes that allow open dialogue and foster trust,²⁰⁸ and the Los Cabos initiatives to strengthen accountability are a positive sign. However, in some cases the hopes for the future — its evolution into a framework that might facilitate genuine negotiation between participating countries and the establishment of mutual

commitments as part of a conditional international agreement, and possibly even eventually a rules based coordination system²⁰⁹ — seem excessively optimistic. The world's pre-occupation with the Euro Area's difficulties distracted MAP participants from the initial intended medium term focus, while Euro Area governments remain reportedly reluctant to engage on what they see as internal policy and governance issues with G20 counterparts through this process. The initial reluctance to buy into the process by some EMEs²¹⁰ in time gave way to an increased sense of commitment and ownership. Anecdotal evidence suggests that the MAP has highlighted the value of a structured, multilateral opportunity for Ministers to give vent to candid views and clear the air on some issues, such as media talk of 'currency wars'.²¹¹ Informal reports suggest these discussions left Ministers with a better understanding of each other's views and concerns and a less adversarial atmosphere surrounding the issue.

Nevertheless, continuing frustrations with the failure of the MAP

to achieve stronger domestic policy commitments that went beyond 'no regrets' undertakings and to demonstrate a higher level of shared ambition, have most recently led to efforts to re-badge the process, focusing on its core objective — raising domestic and global growth. This rebadging offers the potential for obtaining greater domestic traction and support for the more challenging commitments needed if, indeed, higher growth rates are to be achieved. In this context, the emerging focus on addressing the issue of domestic investment environments, and most recently G20 members' infrastructure needs in the context of varying degrees of national fiscal constraint is likely to resonate well with domestic constituencies. It might also help build common ground among G20 members who might otherwise face divergent interests on key macroeconomic policies, specifically, the US Fed's rollback of extraordinary monetary policy easing. This will however inevitably increase the prominence given to sensitive domestic structural policy issues, while it will remain

- 207 Were these inputs classified as surveillance, under its Articles the Fund would be obliged to initiate and control the process, requiring participation and the provision of information by members, and the Executive Board would have a right to provide commentary on, and seek to influence the contents of the draft inputs before their communication to the G20. The primacy of G-20 ownership would have been seriously dented if not destroyed. The legal classification of the inputs as technical assistance, taking into account not just the subject matter but the nature of the exercise, is a device to ensure that Fund Staff and Management can prepare the inputs without any Board involvement, sharing the material with the Board only at the same time as it is provided to the G20. It speaks volumes for the malleability of the Fund's legal framework, to be able to justify pragmatic approaches when needed. It also underscores the reluctance of the G20 leaders, Ministers and their Deputies to have the Fund's Executive Board intervene in the process. Their concern was that, at a minimum, such intervention would merely delay the process, with limited value added, while it would expose the process to the risk of pressures to massage the analysis and soften the key messages.

While broadly supported by the G20 representatives around the Board, this approach has been a continuing irritant for non-G20 Board members (with some mischievously asking if the Fund would charge for this 'technical assistance' as it had contemplated doing more generally). More interestingly, some G20 EME Board members were also vocal in questioning this approach during the early days of bedding it down. It is possible that some Directors were motivated by their position on the Board, and a desire for personal involvement, while others may have taken a principled position to protect the Board's prerogatives. However, one also had the impression that their authorities were happy to hedge their bets, and preserve the ability to look to the cover that might be provided by the Fund's 'rules based' approach, and its application in the more dysfunctional setting offered by the Board, to protect their national interests.

- 208 See, e.g. Creon Butler, Op.cit, (2012) and Robert Lavigne and Subrata Sarker, Op.cit (2013)
- 209 Creon Butler, Op.cit (2012) page 471
- 210 The Fund has also sought to play down talk of currency wars, for example, Managing Director Lagarde's press conference, dated February 16, following the Moscow meeting of G20 Finance Ministers and Central Bank Governors, where she said "There has been a lot of talk about a currency war and we have not seen any such thing as a currency war. We have had currency worries, not a currency war. We have not seen confrontation, but dialogue, deliberation, discussions, and clearly this G-20 Moscow meeting has been extremely helpful and productive in that respect." The April 2013 World Economic Outlook attempts to place such concerns in perspective, noting that "currencies have responded appropriately to recent changes in macroeconomic policies and falling risk aversion."
- 211 China, in particular, was reportedly very laggardly in providing the initial country level inputs requested, raising concerns about its commitment to the process.

necessary to manage tensions between G20 members' on macro policy settings, at least in the short term. It will be interesting to see how the G20 process continues to adapt to such sensitivities while preserving the integrity and collective ownership of the process.

Lessons

What overall conclusions can one draw about the nature and limitations of Fund surveillance/policy cooperation from this experience?

It is worth highlighting that, while external commentators have bemoaned the inadequacy of the Fund's 'rules based' system and put forward various suggestions to strengthen it, in practice the Fund has chosen largely to eschew rules in favor of extensive investment in strengthening its analysis and improving the available tools to engage policy makers. For its part, the G20 has looked to harness these new tools in support of an experiment in voluntary cooperation, built around information exchange, dialogue and mutual accountability, and dependent

on sustaining a strong sense of ownership.

This is not surprising. Calls for tougher rules, such as the Palais Royale Initiative's²¹² suggestion of policy and exchange rate norms which if breached would trigger appropriately graduated sanctions, including possible financial sanctions, seem very unrealistic when one considers that this would have to be supported by the same nation states which have consistently demonstrated considerable reserve in the implementation of the existing rules. The underlying appeal of a 'rules based' system in a world of sovereign nation states lies less in the potential scope it offers to discipline peers, and more in the respect and protection the rules afford to national policy prerogatives. For many, especially those who may feel at risk of being similarly targeted in future, overt action to sanction a sovereign state for breach of the rules is a step to be taken with great caution and a wary eye on the precedent it establishes. As the distribution of global economic weight, and power, becomes more

dispersed and less asymmetric, the resulting tendency to inertia is only likely to intensify.

A case in point is the Fund's recent treatment of Argentina regarding a breach of its obligations under Article VIII, section 5, of the Fund's Articles. This is a long standing issue, relating to the Fund's concerns regarding the quality of Argentina's inflation and GDP data, and the first time such a censure has been issued. Fund Staff, Management and the Board have each moved very cautiously down the path of first testing the authorities' willingness to fix significant shortcomings in data considered essential to the Fund's surveillance role, and then signaling the Board's intent to consider formal sanctions. Technical discussions with the Argentinian authorities on this issue date back to at least 2010, and the Board first formally signaled its concern to the authorities in February 2012. As it is, the censure issued a year²¹³ later stops short of formally

using the sanctions available under the Articles, starting with a declaration of ineligibility to use Fund resources. Moreover, the Fund's subsequent announcement in December 2013 retreats from any threat of imminent sanction, as the Executive Board appears to have again clutched at the promise of remedial actions by the authorities in the hope that such sanctions won't be needed.²¹⁴

This slow and laborious process of reluctantly escalating pressure on the authorities of a member whose breach of a fundamental obligation is unarguable underscores the cumbersome nature and questionable efficacy of reliance on the Fund's legal framework to deliver cooperative outcomes

The clear conclusion this experience suggests is that 'legal' obligations in the international sphere are only as good as the strength of the collective political consensus that underpins them. And 'legal'

213 Statement by the IMF Executive Board on Argentina, Press Release No. 13/33, February 1, 2013

214 Statement by the IMF Executive Board on Argentina, Press Release No 13/497, December 9, 2013

solutions will not be effective if they attempt to get ahead of that consensus. The Fund's ISD is an attempt to codify existing accepted desirable concepts and practices, and no more than that; in the process of doing so, however, it has provided valuable political cover for an important player, China, to buy back into the concept of surveillance in the wake of the difficulties created by the earlier 2007 decision. Its political value far outstrips its legal value. Equally, led most recently by the EMEs, the membership has consistently resisted all efforts to impose constraints of any kind on national policies regarding capital flows, even when in Fund Staff's view the proposals being made are eminently flexible, non-doctrinaire and pragmatic.

In this context, suggestions that the Fund's exchange rate surveillance²¹⁵ should be remodeled along the lines of the WTO's dispute settlement mechanism seem farfetched. The WTO is essentially a framework for managing a system of bilateral trade agree-

ments. Its dispute settlement arrangements, put in place in the mid-1990s, represents a significant development in trade relations, allowing recourse to an independent panel to adjudicate on whether countries have breached their bilateral agreements, and where appropriate determining carefully calibrated, offsetting penalties. Putting aside the added complexity of attempting to apply such an approach to a multilateral system, such as the international monetary system, in which one would expect any breaches of obligations to have multilateral and potentially systemic impact, countries would also be exposing themselves to external intervention in an area of policy (exchange rates and monetary policy) which directly affects the full sweep of domestic economic activity, in a way that bilateral trade does not. Agreeing to a system that gives outside parties such overt potential influence over such fundamental domestic policy choices is likely to be much harder for national governments than signing up to independent enforcement of bilat-

215 E.G. Paul Blustein, Op.cit

erally negotiated trade agreements. This is likely to prove a major constraint, even were concepts such as exchange rate manipulation relatively easy and straight forward to explain and establish — and quantify — in practice, which is clearly not the case. The cautious way in which the WTO has chosen to handle recent efforts by some parties to test the waters regarding WTO jurisdiction over exchange rates suggests little enthusiasm for getting into this space.²¹⁶ One should not lose sight of the fact that the same governments that are members of the WTO are also members of the Fund where they implicitly endorsed the latter's 'loose' rules based approach. It seems very unlikely that they are going to be willing to put that approach to the test in a competing forum.

Martin Wolf arguably best captured the practical constraints facing Fund surveillance in a paper commissioned for the 2011 Triennial

Surveillance Review in which, with reference to the Victorian journalist Walter Bagehot, he described the IMF as the constitutional monarch of the international monetary system, exercising '...the right to be consulted, the right to encourage and the right to warn.'²¹⁷ He went on to suggest five inherent impediments to the Fund's effectiveness in this task, which he called the six 'I's — ignorance, ideology, insularity, incentives, intimidation, and impotence. In this context, the Fund's focus on strengthening its knowledge and skills base, addressing the pervasive challenges of silos and groupthink, while turning its attention to the internal incentive structure, is entirely understandable.

The side effect, however, has been to add further to an already burgeoning suite of surveillance products, with the risk of product indigestion among the membership.²¹⁸ The challenge of engaging national policy decision makers

216 In March of 2012, following press reports that the Brazilian authorities had raised the issue of trade tensions driven by exchange rate concerns, the WTO opted for a broad ranging seminar on the topic of exchange rates and trade. In his introductory remarks the WTO Director General was at pains to stress the complexity and longstanding nature of the issues involved, and to emphasize that trade policy and the WTO cannot be expected to solve the problems of the international monetary system, on which he was happy to defer to the IMF.

217 Martin Wolf, *Surveillance by the International Monetary Fund*, (IMF, 2011)

on a set of clear and concise messages remains problematic. New reports per se are unlikely to improve the Fund's effectiveness in getting traction — that is, influencing policy — in systemically important economies such as the US. (Joseph Stiglitz has observed that, during his time as Chair of the US President Clinton's Council of Economic Advisors, Fund surveillance had 'zero impact' on US policy thinking.)²¹⁹

The term 'surveillance' is itself arguably unfortunate, in so far as it implies a somewhat disengaged policing role for the Fund, monitoring members' policies from a distance. To be effective, Fund surveillance has to be a shared responsibility among the membership, with collective buy in to the process. Put another way, the 'Fund' in 'Fund surveillance' is the membership, not just the secretariat based in Washington, D.C.

Nor is it useful to think in terms

of a model whereby the Fund provides purely independent, technical assessments, and relies on transparency and technical excellence to get the messages across. The subtle art of getting traction with sovereign governments while preserving a constructive relationship, built in part on the recognition of the Fund as trusted advisor, requires a high degree of political savvy on the part of the Fund. Hence, the potential value — albeit not always delivered — of the current Executive Board of member elected officials, juggling their dual role as officers of the Fund and representatives of their countries, over, say, an independent board of outside experts. The inherently political nature of the process has to be accommodated; it cannot be assumed away.

The MAP approach, building on its country ownership, offers the best hope of engendering this sense of shared responsibility. It is a significant experiment

218 Calls from various Board members to consolidate and streamline the increasing plethora of surveillance products have largely gone unheard, in major part because of institutional inertia and internal efforts to protect 'turf' — the inevitable response of a deeply ingrained silo culture.

219 Joseph E. Stiglitz, *TSR External Commentary – A short Note on Surveillance and How Reforms in Surveillance Can Help the IMF to Promote Global Financial Stability*, (IMF July, 2011) page 1.

emerging from the crisis, and one which it is worth persevering. As others have commented, the institutional arrangements that have been established are in themselves valuable, as is the facilitation of structured regular exchange between officials in the key systemically important economies.²²⁰ However, its position remains fragile. It is an experiment that will need to be carefully nurtured, and given a chance to demonstrate its value while avoiding an unnecessarily confrontational approach. A premature preoccupation with mechanistic policy indicators, the thinly veiled pursuit of overtly bilateral agendas, and/or efforts to overreach into the detail of policy areas that touch too many domestic nerves, could threaten to derail the process before it can firmly establish itself.

Effective surveillance, in the sense of effective mechanisms to build shared understandings of the policy challenges facing the

global economy and to exchange perspectives on national policy settings with a view to enhancing cross border consistency and nudging national authorities towards some semblance of coordination, is vitally important in the interdependent world we live in. However, it is also a world of sovereign states whose overriding accountability must be to domestic constituencies, and moreover a multi-polar world in which the task of forming a consensus around anything other than a fairly low common denominator set of undertakings is becoming more challenging. Inevitably, surveillance will be a compromised and far from perfect process in this environment. In this context, while external commentators may wish for greater discipline and tougher rules, the international community has instead embarked on the only realistic path likely to gain support, that of efforts to strengthen the quality of the Fund's analysis and dialogue with members while supporting the

220 Robert Levine and Subrata Sarker, *Op.cit.*, (2013)

G20's fledgling experiment in voluntary cooperation.

GOVERNANCE REFORM

Governance reform, and in particular, satisfactorily addressing the misalignment between Fund voting shares and the rapidly changing distribution of relative economic weight and influence, remains central to efforts to strengthen the broad ownership of Fund surveillance and its traction among the membership. The negotiators at Bretton Woods understood that alignment of the governance structure with global political and economic realities was crucial both to the Fund's legitimacy and, in more practical terms, to ensuring that the key national players felt any commitment to making the institution work.

This is not only relevant to the efficacy of surveillance; it is absolutely essential when it comes to ensuring the Fund is adequately resourced to play the role expected of it. It was no

coincidence that, alongside the call for a trebling of Fund resources, G20 Leaders in London committed to 'reform [the international financial institutions'] mandates, scope and governance to reflect changes in the world economy', and to ensure 'that emerging and developing economies, including the poorest, must have greater voice and representation.'²²¹

By the Pittsburgh meeting, as noted earlier, an ambitious governance agenda had been further fleshed out. Leaders committed to preserving the IMF as a quota-based organization, thereby re-affirming the underlying wisdom of the Bretton Woods model. They undertook to urgently implement the 2008 package of IMF quota and voice reforms. Moreover, the next major review of Quotas, the Fourteenth General Review, was to be completed on an accelerated timetable, by January 2011. It was to achieve '...a shift in quota share to dynamic emerging market and developing countries of at

221 G20, *London Summit – Leaders' Statement*, (April 2, 2009) paragraph 20

least five percent from over-represented to under-represented countries using the current IMF quota formula as the basis to work with.' And G20 Leaders identified other critical issues to be addressed, in particular: the size and composition of the Executive Board; options to improve the Board's effectiveness; the need to strengthen Fund Governors' strategic oversight of the Fund; enhancement of staff diversity; and the use of an 'open, transparent and merit-based process' for the appointment of the heads and senior leadership of all the international financial institutions, including the Managing Director and Deputy Managing Directors of the IMF.²²² In the context of finalizing the Fourteenth General Review of Quotas in late 2010, G20 Leaders subsequently endorsed a comprehensive review of the quota formula to be completed by January 2013 '...to better reflect the economic weights', and the intention to bring forward the Fifteenth General Review

of Quotas to be completed by January 2014.²²³

Subsequent Progress on this agenda has been mixed. An examination of this track record reveals much about the nature of the challenges facing international economic governance in the current environment.

An 'open, transparent and merit based' process for the appointment of the Fund's senior leadership

In 2009-10, it was widely speculated that 2011 would provide an opportunity to test the political willingness to break with the historical convention, dating back to the Bretton Woods conference, that the head of the IMF was always a European nominee, while the head of the World Bank was always an American. In the event, the IMF MD position did become vacant during 2011, albeit in circumstances which were extraordinary and unanticipated.²²⁴ The Fund's membership was

222 G20, *Leaders' Statement – The Pittsburgh Summit*, (September 24-15, 2009), paragraph 21

223 G20, *The G20 Seoul Summit Leaders Declaration*, (November 11-12, 2010), paragraph 16

therefore confronted with the need to quickly fill the position, also aware that the new appointee would then have to appoint a new First Deputy Managing Director, also by political convention always an American, early in their term.²²⁵ The outcome, an appointment of another European, underscored the challenge of sustaining the political commitment needed to jettison this anachronism.

The appointment of the Managing Director is a matter for the Executive Board, technically requiring a simple majority of votes cast. However, this is a matter on which Board members will invariably seek instructions from their authorities. Moreover, the Board would in practice seek to achieve a broad consensus in favor of the successful candidate, as a demonstration of unity and institutional strength. In this connection, as of March 2011 when the 2008 package of Quota and Voice reforms had taken effect, an alliance

between the European and US representatives on the Executive Board would still produce a small but comfortable absolute majority of total voting power, even without the support of the Spanish chair (which represented a predominantly Latin American emerging market economy constituency).

A working Group of the Executive Board had earlier, in 2010, proposed a framework decision regarding revised process for selecting the new Managing Director. Drawing on this work, a decision was quickly reached on a selection process which broadly met the test of openness and transparency and was capable of delivering a strong merit based appointment, without reference to the nationality of the successful candidate.²²⁶ The nomination process was opened up to any Fund Governor or Executive Governor, clear expectations were set out regarding required qualities and experience, the process

224 Dominique Straus-Kahn resigned from the position of IMF Managing Director on May 18, 2011, following his arrest in New York on charges of sexual assault. It had earlier been speculated that the then IMF Managing Director, Dominique Strauss-Kahn, would announce his resignation from the position sometime in 2011, with an eye to winning the socialist nomination for the 2012 French presidential elections.

225 The incumbent First Deputy Managing Director, John Lipsky, had announced that he did not intend to seek re-appointment at the end of his term in August 2011.

for shortlisting and the eventual appointment, and a timetable for the process was established and made public. There was even a reference to the shortlisting process being undertaken ‘without geographical preference’. However, the decision was deliberately silent on the matter of whether there was any commitment to put aside the established nationality based conventions — it was recognized that this was not a matter of process, but rather of the political willingness of the US and Europeans to walk away from this unwritten deal in the broader interest of the Fund’s legitimacy.

It was notable, therefore, that the G20’s agreed rubric — an open, transparent and merit based process — stopped short of saying anything about the nationality of the successful candidate. There had been earlier indications that it was understood at the time of his appointment that Strauss Kahn would likely be the last European Fund Managing Director for some

time. There had also been hints that the Europeans would be open to breaking with the established convention, but only if the US undertook to give up its claims on the World Bank presidency. However, all efforts to reflect that in the political agreement, either in the context of the G20 or the IMFC, by adding words to the effect that the process would not have reference to the nationality of the successful candidate, had been consistently rebuffed, with the Europeans happy to hide behind the strong resistance of the US.

In the event, there proved to be overwhelming support for the European candidate, Christine Lagarde, the then French Finance Minister. Among non-European and non-US countries represented on the Board, only the Canadian and Australian Governors publicly indicated support for the EME candidate, Augustin Carstens, the highly respected Mexican Central Bank Governor, and former Fund Deputy Managing Director.

226 *IMF Executive Board Initiates Selection Process for Next IMF Managing Director*, Press Release No. 11/191, May 20, 2011

In contrast, the Europeans had lobbied hard for Mme. Lagarde, albeit on sometimes spurious and unabashedly euro-centric grounds (such as the claim that only a European would be able to handle the emerging European crisis!), while the US was deliberately noncommittal in public.

The real-politic of the US and European positions is easy to understand. Mme. Lagarde would subsequently nominate the US's preferred candidate to fill the First Deputy Managing Director vacancy, while the US would the following year successfully nominate a Korean born US citizen, Jim Yong Kim, to be World Bank President, thereby retaining its hold on the other side of 19th Street.

The failure of the EMEs to support a non-European candidate perhaps requires a little more examination. It clearly helped that Mme. Lagarde was an impressive candidate. Moreover, one sensed that rivalries among the EMEs and developing countries played a role. It was clear, for example, that Latin American rivalries, especially

Brazilian suspicions that Mexico was too close to the US, would have been unhelpful to Carstens' candidacy, in the same way that Sino-Indian tensions may have been expected to undermine, say, an Indian candidate. Most importantly, however, the EMEs appear to have quickly reached the view that Mme. Lagarde, had a lock on the position, compliments of the US-European voting majority on the Board, and that their individual interests were best served by seeking individual understandings with her on issues they considered important, in return for their joining a broad consensus in support of her candidature.

Selected elements of these understandings were to become apparent during the selection process, and some 'wins' for the EMEs can be identified. In the area of staff diversity, for example, Mme. Lagarde has contributed with both some tangible high profile appointments,²²⁷ and greater personal commitment in championing reform. She has also supported an evenhanded approach to surveillance, including

on the sensitive issue of capital flows. She has also been strongly supportive of delivering the proposed reforms to quota shares.

The opportunity for a significant breakthrough on governance reform, in terms of both substance and symbolism, was therefore undoubtedly stymied by the arithmetic of the existing quota and voting shares. European solidarity held firm. Most importantly, the US clearly placed its domestic interest in preserving a key US presence among the senior leadership on both sides of 19th St, above any weight it may have given to the contribution appointment of a non-European would have made to the credibility of the Fund and its longer term effectiveness. The difficulties confronting the EMEs and developing countries in forging a common position were also understandable. In this context, the strategy of key EMEs to individually seek to exercise leverage over the subsequent direction of policy under the new Managing Director on issues that they cared about

made a lot of sense. However, it could equally be argued that the EMEs were excessively defeatist and this approach undermined any efforts to coordinate an agreed alternative candidate early enough in the process to gain the necessary traction to test the US-European alliance. Only time will allow them to judge if the deals they struck with the new European MD were worthwhile. There has been evidence of growing frustration among the BRICS regarding the limited progress since on key governance issues, although in many cases the major roadblocks to reform have not been within Fund Management's control.

Engaging Governors in the Strategic Oversight of the Fund

This is one aspect of the governance agenda on which it was apparent the new Managing Director was more closely of the same mind as the EMEs. She quickly sought to distance herself from her predecessor's support for activating the Council of Ministers,

227 China can claim the most tangible gains in this regard. Shortly after taking up her position, Mme. Lagarde obtained Board approval to create a fourth Deputy Managing Director position, to which she appointed a Chinese national. She has subsequently appointed a Chinese national to the position of Fund Secretary. Both appointees, it must be noted, were clearly high quality candidates.

a proposal broadly opposed by the EMEs, in favor of efforts to strengthen the effectiveness of the IMFC. The persistent shortcomings of the latter, as a vehicle for ensuring Governors' ownership of the Fund's agenda and political buy in on, say, the key findings of Fund surveillance, remains a core justification for the complementary political leadership role of the G20. Moreover, as a succession of external reports have emphasized, greater clarity about the role of the IMFC would also allow progress to be made about clarifying the appropriate role, respectively, for Board and Management. At present, the Board arguably too often succumbs to the temptation to attempt to micro-manage the institution, at the expense of a more appropriate focus on supervisory and strategic input.²²⁸

As discussed in an earlier section, the proposal to activate the Council, allowed for under Article XII and Schedule D of the Articles, reflected a desire to provide Governors with a greater sense of

ownership of, and accountability for, the Fund. The IMFC's formal status as a purely advisory body and Management's control over its agenda, combined with a tendency towards set piece speech making in a setting involving an excessive number of observers and officials, have all tended to downplay the importance members attach their attendance and engagement. The contrast with the meetings of the G20 Finance Ministers and Central Bank Governors during the recent period, from which attendees appear to take away a strong sense of accountability to deliver on the agreed decisions, is striking.

Opposition to the Council has been driven by a range of overlapping and in some cases interrelated considerations. Some Board members, protective of their status, were resistant to any loss of formal power, even though in practice it offered a chance to improve the Board's strategic influence and effectiveness over the Fund's operations — arguably,

228 See, for example, Independent Evaluation Office, *Ibid*, (IMF 2008), and the Trevor Manuel's Final Report of the Committee on IMF Governance Reform, (IMF, March 2009)

the semblance of decision making was valued more highly than the substance of genuine influence. EMEs and developing countries were clearly concerned that their Ministers would be more exposed in the Council setting, in some cases disadvantaged by poor command of English and with limited scope for support from their officials. As noted in the context of the discussion on surveillance, above, the qualities that contributed to the Board's dysfunctionality could also help provide cover for the protection of national interests.

Most importantly, however, EMEs and developing countries feared that a Council would merely institutionalize ministerial level decision making while what they saw as the fundamental inequity in voting power and voice remained unaddressed. (European willingness to consider the Council did nothing to allay these fears Fund Staff's later attempts to resurrect the concept in a more palatable guise, for example an alternative proposal to transform the IMFC into a new body, to be called the

International Monetary and Financial Board (IMFB), with the more limited transfer of powers from the Board involving those requiring special majorities under the Articles (such as those relating to the adjustment of quotas, the allocation or cancellation of SDRs, and the approval of proposals to change the Articles) , together with decisions relating to the sale of gold, general decisions relating to surveillance policy²²⁹ and, most notably, the power to appoint the Managing Director (with potentially a special majority), received no more support.²³⁰

For its part, the US wavered between a position of passive neutrality to skepticism on such proposals, and clearly was disinclined to use any political capital in their support.

This issue was equally divisive in the G20 context, where, coming out of the Washington 2008 Summit, Australia and South Africa had been asked to jointly chair a working group on *Reform of the IMF* (Working Group No. 3 of the four established at that time). The

Working Group had to contend with strong resistance from EME members to any focus on governance issues which went beyond questions of quota and voice. EME G20 members were often represented by their Fund Executive Directors in these G20 processes, with the result that the G20 official level discussions often did little more than echo the sensitivities at the Fund Board, failing to tap any scope for additional political guidance from capitals.

In this environment, continued efforts by outside commentators to promote a structured solution to the twin problems of legitimacy (of the G20) and effectiveness (of the IMFC), involving some form of merger of the two in which, say, the G20 Finance Ministers Meeting takes on a constituency structure and morphs into the defacto Council,²³¹ have no realistic hope of gaining traction. The EMEs can be expected to continue to resist any proposal that takes decision making powers away from the Fund's Executive Board, where

they see value and protection in the technocratic nature of the process and the avoidance of overt political pressure. At the same time, a key appeal of the G20 lies in its individual country based membership, and the greater resonance this has with domestic interests. There is no interest among G20 members in shifting to a constituency based system, no matter how intellectually appealing that may be to some.

Efforts to improve ministerial (i.e. political) engagement have therefore relied in part on strengthened leadership and in part on what, in July 2010, Fund Staff termed 'the banality of procedural reforms.'²³² The IMFC chairmanship of the Singaporean Finance Minister, Tharman Shanmugaratnam, has brought greater focus and more inclusive processes to the Committee's biannual meetings. Draft communiques are circulated early and significant effort is made to reflect a true consensus view. Improvements have also been made to the format of the meetings,

229 The proposal also allowed for the IMFB to discuss selected multilateral surveillance reports, such as spillover reports, in an effort to enhance traction.

230 See International Monetary Fund, *IMF Governance Reform*, (July 7, 2010),

231 Ideas along these lines have been put forward in the context of the Palais Royale Initiative, and have been regularly repeated in other contexts.

with greater use of closed restricted sessions and opportunities for more informal exchange (despite lingering reluctance from EME and developing country Board representatives to placing their Ministers in situations where they do not have access to advisers and where they may be disadvantaged by their lack of command of English). But a solution to the basic challenge remains elusive: how can one facilitate among IMFC members a greater sense of ownership of, and — arguably more importantly — accountability for, the outcomes of their meetings, and hence for the role and operations of the Fund?

The outlook, therefore, is for continuation of the existing complementary yet uncomfortable partnership between the formal structures of the IMF and the more overtly political arrangements of the G20, of which non-G20 members will remain suspicious and resentful. In this world, G20 EME members can be expected to continue to selectively

use one forum or the other to pursue their interests, depending on whether they are looking for the protections of the Fund's 'rules based' system (as in the case of their attempts to vet the Fund's contributions to the MAP, discussed above), or the leverage offered by the G20's consensus based decision making in which all participants have equal weight (for example, on issues such as the quota formula review — to be discussed below).

Reforming the composition of the IMF Board

At their meeting in Gyeongju, Republic of Korea, in October 2010, G20 Finance Ministers and Central Bank Governors agreed on a package of reforms to give effect to the Pittsburgh commitments. Alongside understandings reached regarding the 14th General Review of Quotas (to be discussed further below), a key element was agreement that the number of advanced European country chairs on the Board should be reduced by

two in favor emerging market and developing country representation.

To help facilitate the consolidation of representation that this would require, it was also agreed that the Fund's Articles would be amended to allow for a fully elected Board, that is, to remove the requirement that the five largest members to appoint their own Executive Director and thereby allow these members to form multi-country constituencies. (As the expected re-alignment of quota shares was expected to change the composition of the five largest members currently able to appoint an Executive Director, this would also help ease the political pain of adjustment.) And a second Alternate Executive Director position would be made available to multi-country constituencies²³³ to also help lubricate the negotiations that would be required to consolidate existing chairs. In this context, a commitment was made to preserve the size of the Fund's Board at twenty-four seats, and to review its composition every eight

years following the completion of the 14th Quota review.²³⁴

The machinations leading to this agreement are worth recounting. The US authorities' previous position had been that it would seek a reduction in the size of the Executive Board from the existing twenty-four seats, to twenty, spread over two Board election cycles. It had the power to do this, as the Articles currently only allow for a Board of twenty Executive Directors, but also allow the Board of Governors to agree at each biennial election to vary the size of the Board, subject to special majority requirement of eighty-five percent — that is, the US, with over fifteen percent of the voting power, could choose to veto any increase in the size of the Board above the twenty seats provided for in the Articles. The US position reflected the view that a smaller Board would be more efficient and would force desirable consolidation of chairs and representation. However, mixed signals had been provided informally by

233 For multi-country constituencies with seven or more members only

234 G20 Communiqué, Meeting of Finance Ministers and Central Bank Governors, Gyeongju, Republic of Korea, October 23, 2010, paragraph 5

US officials through the course of 2009 and the first half of 2010, as to whether it would follow through with this threat. The political fallout for the US from such a heavy handed approach was likely to be significant, and not eased in any way by phasing the adjustment over two election cycles. Indeed, the latter would likely only extend the political pain. It may have been more manageable were the US to be able to put together an alliance with other Fund members, who together could also command the necessary fifteen percent of the vote, to share the opprobrium, but there was no sign that such an alliance was being sought or would be forthcoming.

As the preparations for the 2010 election of Executive Directors got under way, therefore, there had been no indication that the US was actively intending to follow through on this. It was therefore a surprise when the US Secretary of the Treasury, as the US Governor of the IMF, did not cast his vote in favor of the proposed rules for the 2010 election, effectively stymying preparations for an election for

a twenty-four person Board, and US officials indicated that the US was seeking a commitment to significantly adjust the Board's representation in favor of emerging markets and developing countries.

The US position, and its determination to force change, only became apparent in early August 2010, the closing date for the Governors' vote. In the absence of US support for a Board of twenty-four, the Fund would have had no choice under the Articles but to conduct an election by October 31 that year, based on a Board size of twenty. There was little time therefore to broker a deal, and negotiations behind the scene were intense. The US had made it clear that it expected the Europeans to accommodate the adjustments it was seeking. The agreement finally reached at Gyeongju was reportedly only achieved with the very active personal involvement of the then Fund MD, Strauss Kahn and then US Treasury Secretary Geithner. The reduction of two 'advanced European' chairs was to be interpreted in very precise arithmetic terms; for example, a

rotation agreement whereby a chair previously always held by an advanced European country would henceforth be shared fifty percent of the time with an emerging market member would count as a reduction of half a chair.

The new Board composition was to take effect from the first election of Executive Directors to follow the date of effect of the other key aspects of the agreed package, namely the amendment of the Articles and the implementation of the agreed Quota increase and redistribution. The latter required members representing at least seventy percent of the Fund's quotas to take their increased quotas, but was also dependent on ratification of the amendment to the Articles by members accounting for eighty-five percent of the fund's voting power. Once again, therefore, this would be dependent on ratification by the US. The aim, in October 2010, was that this would all be in place by November 2012.

The subsequent US failure to date to ratify the Amendment to the

Articles, as part of a legislative package linked to Congressional approval for the US quota increase, has therefore delayed the proposed deadline for changes to the composition of the Board the US itself had pressed for, until November 2014 at the earliest. And signs that such a delay was likely, alongside the existential distractions confronting the Fund's Euro Area members for much of the period since 2010, have significantly slowed the momentum of internal European negotiations to deliver the required consolidation of chairs.

In April 2012, the Swiss and Polish authorities announced a rotation arrangement under which they would share the chair of their existing constituency, once the other elements of the governance package were all in place, although Switzerland would retain sole membership of the IMFC for the constituency. After protracted, and reportedly difficult, on-again/off-again negotiations within the previous Belgium and Dutch led chairs, at the November 2012 Board Election, Belgium and

Luxembourg joined the Dutch led constituency with a permanent claim on the second Alternate Executive Director position.

The remaining members of the previous Belgian constituency are now represented by Austria on the Board, but have agreed to a rotation arrangement to share the seat equally between Turkey, the Czech Republic and Hungary commencing in 2014.

In terms of the letter, and agreed arithmetic, of the Gyeongju agreement these adjustments will deliver a reduction of one and a half 'advanced' European chairs with effect from 2014. Poland, the Czech Republic and Hungary are considered part of 'emerging' Europe, while Turkey is clearly an emerging market economy. However, it remains to be seen where the other half a chair will come from. It is generally assumed that this will have to involve Spain leaving its current largely Latin American constituency, where it shares the chair equally with Mexico and Venezuela, and joining an existing European constituency. However, this would only

contribute a further third of a chair. Moreover, there are no signs of any movement in that direction, and negotiating a new position for Spain, the fourth largest economy in the Euro Area, within an existing European constituency will not be straightforward.²³⁵ No doubt, among at least some of the current European members who are able to appoint an Executive Director (Germany, France and the UK), thought is being given to the implications of the prospective move to an all elected Board, and the potential this will create to form multi-country constituencies. Nevertheless, it is unclear that the Europeans remain focused on delivering the reduction in two advanced economy chairs.

From the EME's perspective, the prospective changes agreed to date do little to deliver on what they saw as the spirit of the reform, namely a reduction in the European weight on the Board. Increased representation for emerging European countries was not what they had in mind when they agreed to the package of reforms. However, hopes for a

235 The most likely scenario would be for Spain to join the current Italian led constituency, which also includes Greece and Portugal.

fulltime Turkish chair, which was understood to be one of the US's targeted outcomes, have gone unfulfilled as, despite what is understood to have been intensive efforts on its part, Turkey was unable to persuade other members to join such a chair. Progress on consolidating Spain within an existing European chair would help the optics by ensuring one other full time (Latin American) emerging market chair. Other potential new EME chairs are hard to identify: it is difficult to see scope for a sustainable new chair from Asia, already represented by Japan, China, India, the ASEAN group and the joint Australian/Korean constituency; the middle east is arguably overrepresented with chairs held by Saudi Arabia, Egypt, Iran holding a little under nine percent of the voting power, a share that is unlikely to increase on any objective basis; and while a case can be made for a third Sub-Saharan African chair, as has already occurred at the World Bank, the track record on the other side of 19th street is not encour-

aging in terms of the ease of negotiating a new, viable chair.²³⁶

The original deal owed everything to the pressure brought to bear by the US, and the personal involvement of the then Fund MD. However, the extent to which the US will continue to invest political capital in insisting on the deal being honored in full is uncertain. The US Congress's recent failure to include the ratification of the amendment to the Articles and acceptance of its increased quota — crucial prerequisites for the agreed reforms in Board composition — raises serious questions about the capacity of the US to deliver the necessary leadership. Equally, a growing tendency of senior Fund staff, in corridor discussions, to talk up the composition changes delivered to date as significant, and arguably 'good enough', has done little to address growing EME disappointment and frustration. Thus far, it remains to be seen if MD Lagarde's ownership of this aspect of the reform package is as strong as that of her predecessor.

236 The decision to increase the size of the World Bank's Board to 25, to facilitate a third Sub-Saharan African Chair was intended to allow a more even distribution of the burden of representing the 46 members from this region. In the event, however, the new chair was only able to obtain the membership of three Sub-Saharan African members, Angola, Nigeria and South Africa.

There is no doubt that failure to deliver the promised changes to the composition of the Board, and to ensure that the outcome honors not just the letter of the agreement but also its spirit, in terms of a visible reduction in the European presence on the Board, will significantly undermine the credibility of the overall package in the eyes of the EMEs.

Delivering on Commitments to Adjust Quota and Voting Shares

This remains the cornerstone of the governance reform package.

The objective agreed at the Pittsburgh summit — a shift of at least five percent in quota share to dynamic emerging market and developing countries, from over-represented to under-represented countries, using the current quota formula as ‘the basis to work with’ — had emerged as a result of several hours of shuttle diplomacy by the US, during the course of preparing the draft Leaders’ Statement, seeking to

find a form of words acceptable to both the Europeans and the BRICs.²³⁷ The formulation, to be re-iterated by the IMFC at its Istanbul meeting two weeks later, tread a careful path between those focused on the need to recognize the claims of individual ‘dynamic’ emerging markets which had a history of relatively strong growth which was likely to be sustained, and those who saw the goal to be an increased overall share of the Fund’s voting power for emerging markets and developing countries as a group. The latter perspective was and remains entirely incompatible with the principles underpinning the Fund’s governance structure, but nevertheless remained a pervasive theme in the ensuing negotiations, championed by the BRICs and sustained in particular by those emerging market and developing economies which were neither dynamic nor under-represented. The formulation also skirted carefully around the question of whether the new quota formula, agreed

237 It has been suggested to the author by participants in this process that the impromptu caucusing of the BRICs to consider a unified position on this issue was a significant milestone in the effective institutionalization of the group as an established ‘bloc’ within the G20 and IMF governance structures.

as part of the 2008 package of reforms, should continue to be used. In addition, there was a subtle but important evolution in the understandings reached regarding the voice and representation of the Fund's poorest members: in London, G20 leaders had agreed that this should be increased,²³⁸ but by Pittsburgh, the goal had shifted to that of protecting their voting share.

The G20 determination to complete the Fourteenth General Quota review by January 2011 provided the necessary political discipline for the negotiations, which produced an agreement by October 2010, in time for G20 endorsement at Gyeongju. The shape of the agreement, summarized in Box IV-3, says a lot about the tensions and trade-offs involved.

The agreement to eschew inclusion of a significant equiproportional component was particularly important. The dominance of reliance on equiproportional elements in previous quota increases had been

the primary source of inertia in allowing quota and voting shares to adjust in line with shifting relative economic weight. Moreover, it meant the quota formula agreed in 2008 would play a significant role, notwithstanding continuing unhappiness with the compromise formula. For this reason, as will be discussed below, the final agreement included a commitment to a comprehensive review of the formula before it might be used again in the context of the 15th General Review of Quotas.²³⁹

The multifaceted and complex nature of the final deal underscored the challenge of reaching an agreement in the context of a broad range of competing interests and agendas, in what was a zero sum game, and where a broad consensus was needed. The support of eighty-five percent of the voting power would be needed to approve the deal and the aim as always was to have as close to unanimous agreement as possible.²⁴⁰ The central tension

238 G20 London Summit – Leaders' Statement, 2 April, 2009, paragraph

Box IV-3 – Reaching a Deal on the 14th General Review of Fund Quotas

The Agreement involved a doubling of Fund Quotas, allowing for a significant re-alignment of shares. Also, unlike most previous quota increases, there was to be no equiproportional component. Rather, the agreed outcome involved a mix of selective (60%) and ad hoc (40%) components.

The Selective Component was to be allocated to members on the basis of the 2008 Quota formula.

The Ad hoc component was allocated to balance a number of competing objectives:

- It was to be targeted primarily at those members whose share of global GDP (measured as a blend of market exchange rate and PPP values) exceeded their quota share;
- However, the degree of re-alignment for under-represented advanced economies would be limited to half of that for under-represented emerging market and developing countries;
- Members who were under-represented on the basis of the formula (that is, those whose calculated quota share on the basis of the formula exceeded their actual quota share) were to be protected from losing any gains from the selective increase, while over-represented countries under the formula were to be protected from falling below the higher of their calculated quota or their GDP blend share;
- No member would be allowed to suffer more than the lesser of a thirty percent or 0.85 percentage point fall in quota share;
- The poorest members, defined as those eligible for concessional lending from both the Fund and World Bank, were to be protected from having any fall in their individual quota shares.

- *A cap of 220 percent was placed on the maximum gain in potential individual quota share (a binding constraint for China, Luxembourg and Turkey), while advanced economies agreed (with varying degrees of reluctance) to forego 1.35 percent of their increased quota shares (1.37 percent by G20 advanced economy members).*
- *In addition, there were a number of bilateral deals struck, most notably:*
- *France, Germany, Italy and the UK each agreed to redistribute 5 basis points in quota share to Spain, which remained significantly under-represented.*
- *The US, whose quota share would fall slightly relative to the 2008 deal but still be higher than prior to the 2006 reforms, agreed a bilateral deal to transfer a small amount of its quota share to Saudi Arabia, one presumes to help ease the political pain of the latter slipping out of the top ten largest Fund members ranked by quota share*

throughout the negotiations had revolved around the interpretation of the commitment to a shift in quota share of at least five percent. From who to who was this shift supposed to occur, from advanced countries as a group to the group of emerging and developing country members? While the Pittsburgh formulation did not say this, it was nonetheless the benchmark for a credible outcome claimed by a number of EMEs, and in particular some of the BRICs. A stricter interpretation of the commitment still required agreement on how to define 'dynamic' in the context of emerging market and developing countries, while 'from over-represented to under-represented' begged the question of over and under-represented against what yardstick. The agreement to use the existing formula as the 'basis to work with' still left considerable room

to debate the extent to which the formula should determine the re-alignment, and while the new formula had only been agreed as part of the 2008 reforms, that agreement had involved a number of compromises that had left many Fund members, on either side of the various debates, unsatisfied. It was inevitable that the Fourteenth Review would attempt to revisit those issues, notwithstanding the limited time available to reach an agreement.

The use of the formula as the basis for the selective increase, alongside a country's share of global GDP (blending market exchange rate and PPP values on the basis used in the formula) as the primary benchmark for judging over or under-representation, was an attempt to strike a balance between those who favored a higher weight for GDP and those who preferred to downplay GDP

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- 239 Previous Quota increases had been made up of an equiproportional component, allocated to all members in proportion to their existing share, together with a selective component, aimed at adjusting Quota share and usually allocated to all members in line with the Quota formula, and ad hoc increases for selected members. The equiproportional component had generally accounted for over half, and in some cases up to ninety-eight percent of the total increase in quotas. Only the Eighth General Review had resulted in an equiproportional component that was less than half the total increases. In that case, it was forty percent.
- 240 In the event, the Board of Governors' Resolution was approved by over 95% of the voting power, with only three members (Bolivia, Libya and Yemen) voting against, and seven abstentions, the most notable of which were Nigeria and Switzerland.

relative to the other variables in the formula. The set of ‘dynamic’ emerging market and developing countries was defined as all those who were under-represented, together with those whose share of global PPP GDP was greater than their quota share on the basis of the 2008 reforms, but (to avoid over benefiting some) whose over-representation was not greater than twenty-five percent. Simplicity and transparency were clearly not high on the list of agreed objectives.

Tables IV-1 and IV-2 shows the key outcomes of the review, in terms of the ranking of the largest members and the overall shift of quota and voting share between key groups.

Post-2008 reform				
Top Ten Fund Members	Quota Shares (%)	Voting Shares (%)	Ranking	Quota Shares (%)
US	17.67	16.73	1	17.4
Japan	6.56	6.23	2	6.46
Germany	6.11	5.80	3	5.55
France	4.51	4.29	4	4.23
UK	4.51	4.29	5	4.23
China	4.00	3.81	6	6.35
Italy	3.31	3.15	7	3.16
Saudi Arabia	2.93	2.80	8	2.10
Canada	2.67	2.55	9	2.31

TABLE IV-1: 14TH GENERAL REVIEW OF QUOTAS (IN PERCENT OF QUOTA OR VOTING SHARE, UNLESS OTHERWISE INDICATED)

Russia	2.49	2.39	Brazil	2.71	1.78	2.59	1.71	9	14
India	2.44	2.34	11 Total	2.75	58.98	2.65	56.09	8	

Total for:

Advanced economies	60.5	57.9		57.7	55.3	
Emerging Market and Developing Countries	39.5	42.1		42.3	44.7	

Shifts from Post-2008 reforms to:	Quota Shares (shift in p.p.)	Voting Shares (shift in p.p.)
Under-represented Countries	6.2	5.8
Under-represented EMDCs	5.7	5.4
Dynamic EMDCs	6.0	5.7
EMDCs	2.8	2.6
Shift to EMDCs including 2008 reforms	3.9	5.3

On this basis, the agreement promised to produce a shift of 6 percent in quota share to ‘dynamic’ emerging market and developing countries, 6.2 percent in favor of under-represented countries, and 5.7 percent to under-represented emerging market and developing countries. The shift in favor of emerging market and developing countries as a whole would, however, be only 2.8 percent, and could only be presented as exceeding 5 percent when combined with the outcome of the 2008 reforms, at that point approved but not yet having taken effect.²⁴¹

However, it was notable that the principled insistence of certain EME/BRIC countries on a larger shift of quota share to emerging market and developing countries

TABLE IV-2: 14TH GENERAL REVIEW OF QUOTAS — SHIFT BETWEEN GROUPS

	2.32	2.22	10
	59.66	56.72	

as a group quickly dissipated once the terms of the deal had been set individual outcomes. In particular, Brazil and India began to signal a markedly more accommodating stance in the negotiations once it was clear a deal was in prospect that would place them among the top ten ranked members by quota share, displacing Canada and Saudi Arabia. For its part, China, taking a characteristically long view, was relatively relaxed about accepting its new ranking as the Fund's third largest member in terms of quota share, behind the US and Japan, no doubt confident that time and its inexorable rise would see it supplant Japan in due course.

Overall, the outcome represented a significant step forward in terms of better aligning the Fund's governance with global economic — and political — realities. This is reflected not only in the greater prominence to be given to the BRICs, but more generally to emerging market economies such as the Republic of Korea, Turkey, and Mexico. While anomalies

remain, the more egregious among them, such as Saudi Arabia's continued over-represented position, are being progressively addressed.

Nevertheless, resentment lingered among members who feel they bore too large a share of the burden of adjustment. In addition

241 There was clearly an inherent tension to be managed with the underlying philosophy of the Fund's governance structure. The latter requires the relative influence of each individual sovereign member is aligned in broad terms with their individual economic weight. This is obviously at odds with an approach which would seek legitimacy by ensuring a particular balance between categories of members. Re-alignment of individual members' quota shares in line with changing global relativities must invariably involve winners and losers within both advanced and emerging market and developing countries. The latter clearly included some who were over-represented against any accepted objective criteria, for example many of the middle-eastern countries. (Saudi Arabia is a particularly dramatic example, whose quota share remains almost sixty percent above its calculated quota using the formula and a good two and a half times larger than its share of global (blended) GDP.) Attempts to isolate groups of countries from sharing the burden of the adjustment must inevitably increase the risk of perverse outcomes on others.

to the over-represented emerging markets and developing countries, many smaller advanced or transitioning (predominantly European) countries expressed concern that the weight given to GDP meant that they carried a disproportionate share of the adjustment burden. A number of advanced economies found the haircut, introduced at the last minute to help get the deal across the line in terms of the overall shift of quota shares, particularly difficult to accept.²⁴²

Equally, it was clear that, from the perspective of the EMEs, and in particular the BRICs, this was no more than a step in a larger process, and moreover a process that was to be approached with a degree of urgency. Had it been delivered, the Gyeongju agreement to again bring forward the next (Fifteenth) general review of quotas to be completed by January 2014, would have produced the fourth review of Fund's quotas in the space of eight years. Indeed, in contrast to the Articles' expectations that general reviews be conducted at five yearly inter-

vals, the Fund's quotas have been under almost continuous review over this period. While this may be justified in terms of the need to match the pace of global change, it has also meant that a fundamentally divisive issue for the Fund's membership has loomed large throughout this period when intensified efforts at international economic cooperation were also required.

In the event, The Fourteenth Quota Review has not yet come into effect, and the fifteenth has been delayed apparently indefinitely. Its date of effectiveness is linked to the ratification of the proposed amendment to the Articles to create an all-elected Board, discussed earlier by members representing over 85% of the Fund's voting power. To date, the US has not been able to pass the necessary legislation through Congress. It became apparent through the course of 2012, that this was not something that the Administration was prepared to put to Congress during an election year. The targeted end-2012 date of effectiveness

242 This in part contributed to the eventual Swiss abstention.

therefore came and went. While it was subsequently included in the Administration's budget proposals early last year, and most recently in the compromise budget package considered by the US Congress in early 2014, it was stymied by divisions within the Congress on each occasion. The irony of dysfunctional US politics undermining a crucial and symbolically important step in international governance reform initially driven by US leadership is palpable.

Review of the Quota Formula

Notwithstanding these uncertainties, the Executive Board pressed ahead through the course of 2011-12 with the agreed comprehensive review of the formula. This involved revisiting issues debated at length only a few years previously in the context of the 2008 Quota and Voice reforms. Moreover, while the quota review offered scope for 'ad hoc' fixes to try to achieve the politically negotiated objectives that had been set for the Fund, the quota formula review would highlight the extent of continuing

underlying differences regarding the 'first principles' framework that should underpin the Fund's governance. These would prove much harder to resolve. Indeed, it is arguable that there was almost no chance of reaching agreement on a new formula which was likely to command broad and sustained support and not just be seen as an interim second or third best compromise.

The current formula was itself the product of a difficult compromise produced as part of the 2008 package of reforms.²⁴³ As discussed in BoxII-1, the earlier complex and somewhat opaque system of using five formulas, including a modified version of the original Bretton Woods formula, had been replaced by the following relatively simple and transparent single, linear formula:

$$\mathbf{CQS = (0.5*Y + 0.3*O + 0.15*V + 0.05*R)^k}$$

where CQS is the Calculated Quota Share; Y is GDP, calculated as a blend of market exchange rate and PPP estimates, weighted

by 0.6 and 0.4 respectively, and averaged over a three year period; O is 'openness', measured as the annual average of the sum of current payments and receipts for a five year period; V is the variability of current receipts and net capital flows, measured as the standard deviation from a centered three year trend over a thirteen year period; R is the average level of a country's holdings of official international reserves²⁴⁴ over a year; and k is a compression factor of 0.95 percent.

In terms of the thinking underpinning the formula, the GDP variable was seen as the most direct indicator of economic weight (including ability to contribute to the Fund), while openness provided a measure of a country's integration into the global trading system and, hence, stake in international monetary stability. The inclusion of variability was justified as an indicator of a country's exposure to balance of payments crises and therefore the prospect of having to seek Fund assistance. The inclu-

sion of reserves was a concession to history (reserves had always been included in the formulae in some way or other) and to those countries which argued that this also was a measure of ability to contribute; its small weight was a measure of the skepticism of others on these points. Finally, the compression factor was a device to protect the smaller Fund members by reducing the divergence between the largest and smallest quota shares.

None of these elements had been uncontroversial. While most were prepared to accept GDP as the dominant variable, this was not a universal view. Some (especially smaller Europeans and those with significant financial sectors) had been inclined to argue that the Fund's principle focus on the international monetary system implied openness, expanded to incorporate financial integration, should be the primary variable. The choice of market exchange rate (argued by advanced economies on the basis that the Fund was

243 In 2000, the Fund had commissioned a panel of external experts to review the formula, under the chairmanship of Harvard University's Richard Cooper; the 'Cooper Report' recommended a formula consisting of just two variables, GDP at market exchange rates (with the largest weight) and variability, including variability of long term capital flows. The greater 'complexity' of the 2008 formula reflected the political process that had produced it.

concerned with nominal financial flows) and PPP (strongly advocated by emerging market and developing countries on the basis that it remained the best way to compare economic weight) had been a major sticking point, and the eventual 60:40 compromise had left most parties dissatisfied. A number of larger countries were far from enamored of the compression factor. The agreement reached was therefore a fragile one, and was premised on certain carefully balanced understandings: first that both the inclusion of PPP and the compression factor would be reviewed after 20 years; and second that Fund staff would revisit some ‘technical’ issues before the formula was again used.

In particular, staff would review the scope for measuring openness on a value added basis and the appropriate treatment of intra-currency treatment flows (both of which reflected the concerns of some to avoid giving too much weight to trade within a currency and trade union), whether there

were ways in which measures of financial openness could be directly incorporated into the formula, and whether there were options that could improve the degree to which the measure of variability was a good predictor of demand for Fund resources. On each of these issues, efforts to find a satisfactory solution as part of the 2008 deal had been stymied by both conceptual and technical difficulties, and data limitations. (A key requirement was that there should be robust data available to support any agreed variable for the great majority of the membership.) None of these problems proved any easier to resolve when revisited in the context of the fourteenth review, and so it was agreed — with varying degrees of dissatisfaction — to again kick them down the road and fold them into the ‘comprehensive review’.

In this context, it should be noted that there has been no shortage of external commentary highlighting weaknesses in the new formula. In addition to noting the issue of the appropriate treatment of cross

244 A country’s reserve holdings were defined as its holdings of foreign exchange, SDR holdings, reserve position in the Fund and monetary gold.

border flows within a currency union, Ralph Bryant of the Brookings Institute has also highlighted the questionable practice of expressing both the 'openness' and 'variability' variables as level based, as opposed to ratio based, variables, which are less likely to be strongly correlated to GDP. And he has made a good case for including population, with a small weight, as a means of demonstrating a commitment to an underlying 'democratic' principle in the Fund's governance structure.²⁴⁵

Nevertheless, the Executive Board's failure to reach agreement on significant reforms to the formula as part of 2012 'comprehensive review' should have surprised no one. The report provided to the Board of Governors in January 2013²⁴⁶ puts the best possible gloss on a process that produced little in the way of movement. It indicated a growing willingness to drop variability, given the absence of any clear correlation with demand for Fund resources and very high correlation with GDP, and some inclination to increase the

weight of GDP, but even on these issues there was not a consensus, and all the old arguments were again rehearsed. Neither the technical nor conceptual issues had become any easier to solve in the two years since they were last canvassed in the context of the Fourteenth General Review. More importantly, the underlying impediments to an agreement are neither technical nor conceptual, but inherently political differences, masquerading as technical issues, as key players seek to maximize their position in a zero sum game.²⁴⁷ The complexity of the political 'fixes' reflected in the various ad hoc adjustments needed to get the Fourteenth Quota Review over the line underscores the challenge involved. There is some intellectual appeal to seeking to separate the conceptual 'first principles' that should be reflected in the formula from the inevitable political haggling that might then take place when applying the formula; however, in practice this is a naive distinction. Hence the acknowledgement in January's report to Governors that the issues

245 Ralph C. Bryant, *Governance Shares for the International Monetary Fund: Principles, Guidelines Current Status*, (Brookings Institution, April 2010)

would need to be taken forward in the context of the Fifteenth General Review of Quotas, when, among other things, the tangible trade-offs involved for individual players would be much clearer.

The central debate is that between the preeminence that should be given to economic weight, as best reflected by some measure of GDP and favored by the US, BRICs and other large emerging market economies, and ‘openness’, currently imperfectly captured in the formula and advocated by smaller, more open economies, in particular the Euro area members. There is a philosophical dimension to this debate. Appropriately reflecting economic weight is clearly the cornerstone of the Fund’s effectiveness. On the other hand, the Europeans have an appealing argument that the IMF should seek to explicitly capture some measure of interdependence, such as openness, in its formula, given that, without interdependence there is no international monetary system to oversee. Smaller,

non-European open economies, such as Singapore, have sought to cast the debate in terms of ensuring a balance between the need for buy-in from the larger stakeholders while preserving an adequate stake in the institution by the rest of the membership. The developing country group, the G24, has made similar arguments, emphasizing that the latter is needed to ensure the democratic legitimacy of the institution.

Nevertheless, progress will ultimately require the resolution of competing national interests between groups that each have the potential to block a subsequent quota re-allocation.²⁴⁶ And the agreed principles — simplicity, transparency, consistency with the multiple roles of quotas, statistical feasibility on the basis of timely, high quality and widely available data, and likely to produce results broadly acceptable to the membership — serve to underscore the challenge in finding a purely technical, that is apolitical, solution. A model based on rough justice,

246 International Monetary Fund, *Report of the Executive Board to the Board of Governors on the Outcome of the Quota Formula Review*, (January 30, 2013)

247 For example, arguments in favor of incorporating financial openness and interconnectedness are invariably pressed most strongly by countries with significant financial centers, (most prominently the UK) and resisted by those without such centers.

rather than spurious science, might focus on GDP with a small weight for population. However, notwithstanding rhetoric to the contrary, it is next to impossible to start with a clean sheet in these processes. Medium sized economies such as Australia (including in its role as co-chair of the G20's International Financial Architecture working group), Mexico and others have therefore focused their efforts on identifying evolutionary options that might form the basis of a pragmatic consensus, but which nonetheless enhance the legitimacy of the Fund's governance and progressively facilitate a larger voice for emerging economies.

This is inevitably a slow and frustrating process. As noted in Section II, the history of the Fund's quota formula is one of arcane and difficult negotiations to agree a succession of formulas that the membership has remained reluctant to apply, preferring instead to include significant equiproportional and adhoc components in each allocation of additional quotas

Moreover, in an increasingly multipolar world in which there are a number of key stakeholders who can exercise an effective veto, and a world characterized by a sense of dramatically changing power relativities, there is little incentive to lock in a long term compromise. Rather, the incentive is for all players to seek to keep their longer term options open. Notwithstanding their stake in preserving an effective IMF, European Fund members would clearly hesitate to make long term concessions on the formula if they judge that the other side in this negotiation will inevitably be looking to re-open the issue at the first opportunity that presents itself. For their part, the emerging markets are understandably reluctant to honor a long term binding compromise to the extent that they consider history and the inexorable shift of relative economic weight to be on their side.²⁴⁹

These dynamics are not much easier to manage in the G20 than they are in the IMFC or on the Fund's Executive Board. The

248 While agreement on a new quota formula does not require a special majority, any subsequent quota increase will require an 85% majority of the Fund's voting power.

prime leverage the G20 can bring to the process is a binding time line for reaching agreement, and the reputational capital it puts on the line if the deadline is missed. This has been a powerful tool on a number of difficult issues in the wake of the crisis, but not one that can always guarantee progress. In the case of the 2012 formula review, it has proved wanting.

More generally, it is arguable that the, while the G20 is an essential element in today's international governance arrangements, it suffers some disadvantages compared to its predecessor, the G7/8. Its (necessarily) larger, and more diverse, membership, the lack of a well-established collegial network of like-minded officials, its more dispersed distribution of power combined with evidence of a more selective application of US leadership, a tendency for the positions of the new players to be unduly influenced by long standing suspicions, and in some cases, their limited capacity to develop and prosecute an agenda, all suggest it is likely to be a more

unwieldy instrument for forging political consensus. For example, it is hard to see the G20 emulating the G7's 1990 success in brokering a deal between its members, without recourse to Fund staff of the Executive Board, on how to distribute the cost of significantly increasing Japan's quota share under the Ninth Review.²⁵⁰

The period since the conclusion of the quota reform review has seen something of a hiatus on these discussions. Nor has the G20 added to its guidance, limited to date to the timetable and the general expectation that quotas should continue to be re-aligned with the shifting relative economic weight of Fund members. In particular, no attempt has yet been made to shape expectations with regard to either the size of the quota increase to be agreed or the desired further shift in quota shares, with the scope for the latter heavily dependent upon the former.

249 Some European colleagues expressed frustration to me in the aftermath of the Review that they had felt the Board was close to reaching a compromise but that they had felt the Board was close to reaching a compromise but that the EMEs had 'overplayed their hand.'

Implications for Resourcing the Fund

The implications of the crisis, including the continuing risks and potential demands posed by the subsequent Euro area sovereign debt difficulties, together with the Fund's greater focus on precautionary lending under its various new instruments, have brought a new prism to bear on the question of the adequacy of the Fund's resources, an issue inextricably bound up with progress on governance reform.

The immediate crisis response and ensuing period has seen two distinct rounds of efforts to bolster the Fund's resources: first, the efforts to give effect to the London decision to treble the Fund's resources, and the subsequent agreements to lock in the additional funding initially provided via bilateral loans, by first rolling the agreed increase into an enhanced and expanded New Agreements to Borrow (NAB), the Fund's standing set of bilateral credit lines with members, and then agreeing to re-establish the primacy of quotas

by rolling back the NAB in line with the implementation of the outcome from the Fourteenth Quota Review; and second, efforts through 2011-12 to raise additional bilateral loans, outside of these agreed processes, to strengthen the Fund's capacity to respond to the emerging European sovereign debt crisis.

Fund staff had highlighted that the size of the Fund, in terms of quotas, had by the time of the 2008 package of quota and voice reforms, been allowed to decline significantly relative to key economic metrics. Total quotas needed to be increased by 55 percent to restore the relativity to the level of global output in 1998, the time of the Eleventh General Quota review, the last to produce an increase in quotas. To restore the relativities to global trade and capital flows would require at least a doubling. At the same time, it was easy to come up with potential scenarios concerning the likely pickup in demand for Fund lending that would quickly wipe out its forward commitment capacity as

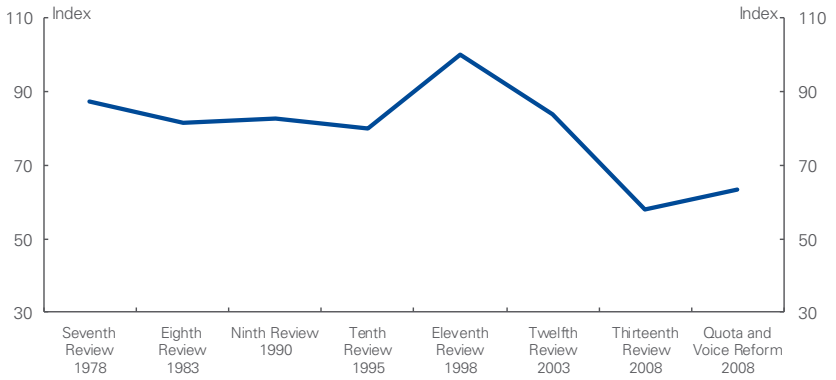
of the end of 2008, even without the potential of fund programs for advanced economy members.

Bolstering resources quickly meant the negotiation of bilateral borrowing arrangements with individual members. The London agreement targeted \$250 billion in such borrowing, to be subsequently rolled into an enlarged (\$500 billion) and enhanced New Arrangements to Borrow (NAB). Japan had been the first to come forward with a direct bilateral loan offer, of \$100 billion, signed with the Fund in February 2009. In March, the European Union announced it was prepared to loan up to €75 billion, equivalent to a further \$100 billion, a decision that reportedly had to overcome resistance from some within the EU yet to be convinced that this was a European problem. Led by the US, other members²⁵¹

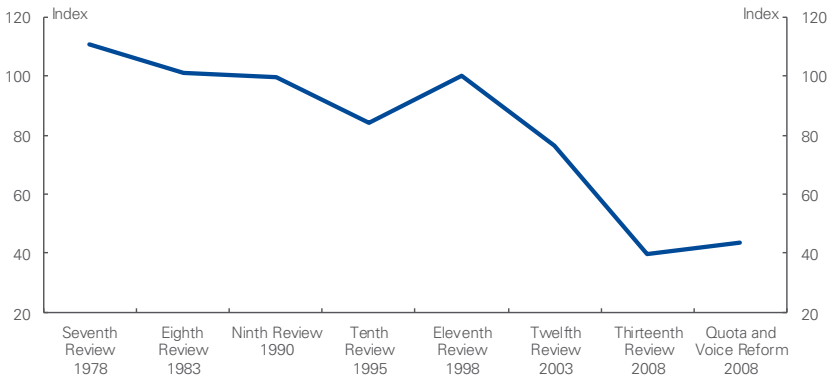
indicated a preference to provide funds through a renegotiated NAB; in April 2009, US President Obama sought Congressional support for a package of IMF related legislation which would include approval for an expanded US NAB contribution of \$100 billion, subsequently passed by Congress in June. In contrast, key emerging markets were notably more hesitant to join the process, even though the participation of the BRICS and others, many of them flush with reserves, this would be a significant statement regarding their evolving leadership role. Negotiations proved protracted against the backdrop of domestic sensitivities. To assist in managing domestic restrictions and perceptions, the Fund developed an option that would allow members to purchase 'notes'; while structured so as to exactly match

CHART IV-1: SIZE OF THE FUND TO KEY ECONOMIC METRICS (INDEX, 1998=100)

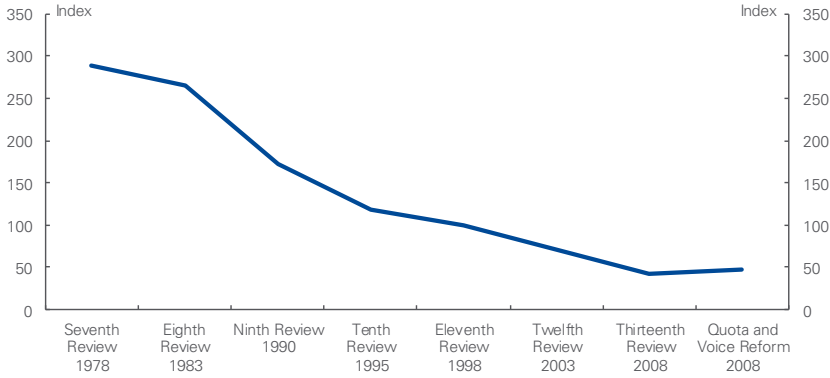
Quotas to World GDP



Quotas to World Trade



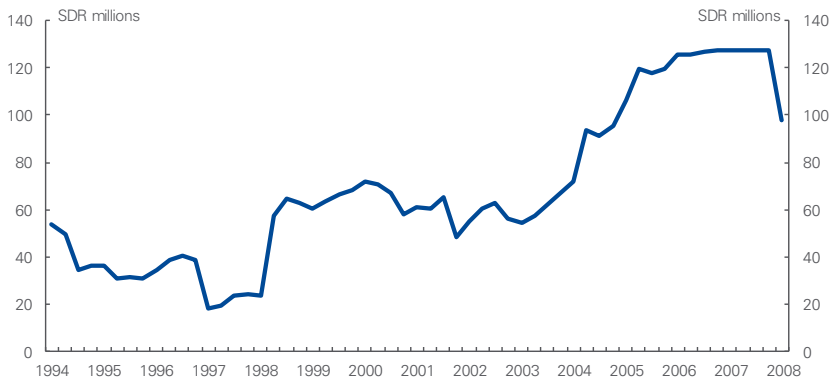
Quotas to World Capital Flows



Source: International Monetary Fund, Review of the Adequacy of and Options for Supplementing Fund Resources, (IMF, 2009).

Notes: Capital flows are calculated using a three-year centered moving average of world capital inflows.

CHART IV-2: IMF FORWARD COMMITMENT CAPACITY (SDR MILLIONS)



Source: IMF Finance Department

the characteristics of a bilateral loan, a notes purchase allowed individual members to present the transaction as an investment rather than a loan.²⁵² Russia was the first of the emerging markets to announce a \$10 billion purchase of fund 'notes', in May 2009. In June, China announced it would enter into a notes purchase agreement for up to \$50 billion, and Brazil followed the next day with a commitment of \$10 billion. China was to eventually sign its agreement in September of 2009, but negotiations with Brazil and Russia would take until January 2010. India announced a \$10 billion commitment in September 2009, and eventually signed in March 2010. The challenges confronting the emerging markets in demonstrating leadership and ownership of the Fund had been underscored, and an opportunity missed to make a clear political statement — especially relative to the Europeans.

More generally, the complex

dynamics of a multipolar world have been evident throughout the efforts since the crisis to increase the Fund's resources.

Agreement was reached on an enhanced NAB in November 2009, although it did not become effective until March 2011.²⁵³ The target of \$500 billion had been exceeded; the expanded NAB had thirteen new members, for a total of thirty nine participants, and credit arrangements totaling SDR 368 billion (or approximately \$589 billion) including an additional European contribution of approximately \$71 billion. Negotiations had been complicated by the reluctance of some existing (European) participants to accept significantly greater flexibility than under the original NAB to activate the credit lines. However, again, another key sticking point, proved to be the determination of the BRIC countries to collectively have a veto over activation and other key decisions, matching that enjoyed by both the US and the European

251 In April 2009, Australia opted to contribute \$5.7 billion through the NAB. Like the US, Australia's institutional arrangements required legislative approval of any loan, and the authorities judged it better to do that in one step, through a contribution to the NAB, rather than have successive separate legislative processes for a bilateral loan and then its subsequent rolling into an enlarged NAB.

252 For example, the Bank of China was restricted in undertaking overseas lending but could undertake investments.

participants. As the size of the enhanced NAB increased beyond the target, the BRICs, other than China, scrambled to scale up their contribution to ensure that together they accounted for over 15 percent of the total.²⁵⁴

The new emerging market participants in the enhanced NAB were also notably active, some might argue heavy handed, in pressing for a cautious approach to managing the NAB, ensuring appropriate burden sharing in the use of the Fund's financial resources across the spectrum of bilateral borrowings, the NAB and quotas (i.e. the General Resources Account or GRA),²⁵⁵ and in ensuring the long term preservation of the Fund as a quota based institution, determined to ensure Some among them have been the only members to express skepticism regarding the proposals to fully activate the NAB, in the context of the emerging Euro Area difficulties, in April 2011, and the subsequent regular six monthly

decisions to renew the activation. . Suggestions that the agreed roll back of the NAB in line with the subsequent agreed quota increase might be delayed or put on hold, while the international community sought to contain growing concerns about the rapidly deteriorating situation in the Euro Area, were strongly resisted by the emerging markets, with the support of the US.

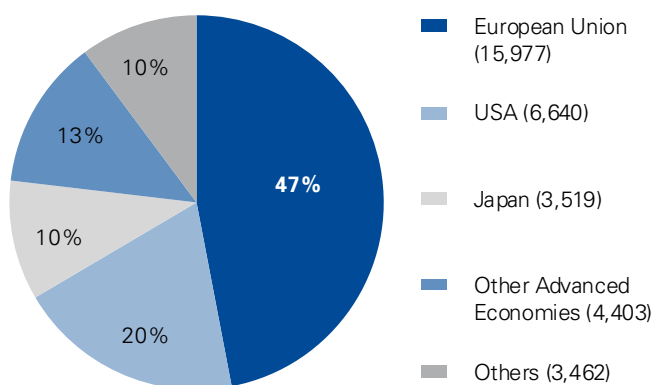
The re-emergence of concerns in the latter half of 2011 about the adequacy of the Fund's resources,²⁵⁶ reflected growing market concerns regarding the difficulties confronting the Euro-Area periphery for its core and for the broader Fund membership. This was to culminate in the further commitment, agreed at the IMF/World Bank Spring meetings in 2012 and subse-

253 The agreement provided that the new NAB would take effect when existing participants, representing at least 85 percent of the existing credit arrangements agreed to the changes, and when new participants, representing at least 70 percent of the new arrangements, adhered to the amendments.

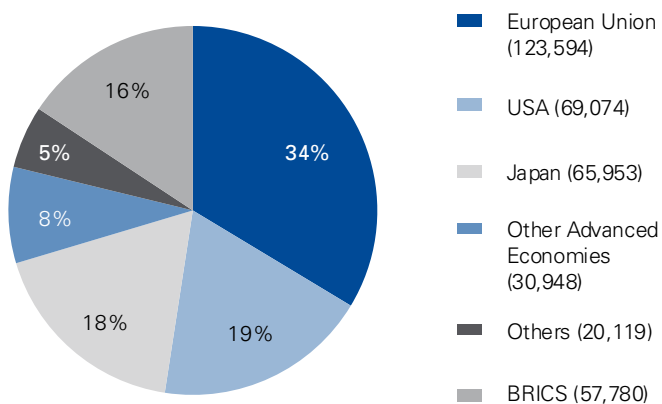
254 Under the final agreement, the BRICs contributed 15.7% of the total credit arrangements: China, SDR 31.2 billion, (or \$50 billion); and SDR 8.7 billion (\$14 billion) each for Brazil, India and Russia.

FIGURE IV-1: ENHANCED NAB (MARCH, 2011)

Previous NAB Contributors (in SDR millions)



Previous NAB Contributors (in SDR millions)



Source: International Monetary Fund, *IMF Activates Expanded Borrowing Arrangements*, Press Release No. 11/109, (IMF, 2011), available at: <http://www.imf.org/external/np/sec/pr/2011/pr11109.htm>.

Notes: Other Advanced Economies includes: Australia, Canada, Hong Kong, South Korea and Switzerland for the previous NAB, and the addition of Israel and New Zealand for the enhanced NAB.

quently re-affirmed at the G20 Los Cabos Summit, of over \$450 billion in additional borrowed resources, outside of the enhanced NAB. This was an important achievement in the context of the Europeans' continuing struggle through that period to put together a response which could get ahead of the curve of market concerns. Nonetheless, its signaling impact was severely compromised and fell short of the success of the earlier London announcements. Efforts to reach an agreement at the 2011 Cannes summit had earlier failed, and the unfortunate release of internal Fund analysis suggesting that the Fund might need to seek \$600 billion in additional resources established expectations that would fail to be met.

There were a number of factors which contributed to this sub-optimal outcome.

First, it was clear that the US would not be prepared to participate. The same constraints that were ultimately to delay the US administration from delivering on the Fourteenth Quota review and Amendment to the Articles were already at. Moreover, the continued shortcomings of the European response, including the Euro Area's reluctance to put together significant internal resources to assist the adjustment pressures confronting its periphery, made participation in such a package problematic for many. Neither emerging and developing country Fund members, nor for that matter advanced non-European country members such as the US or Canada, thought it appropriate for the Fund to be seen to be bailing out a group of advanced economies which should have the collective will, and resources, to tackle its

255 See International Monetary Fund, *Financial Transactions Plan — Temporary Modification of Guidelines for Allocation of Currencies Used for Transfers*, (IMF, March 18, 2011). The arrangements agreed were designed to ensure that the initial disproportionate call on those who had provided funding through 'pre-NAB' bilateral agreements was quickly of-set by significantly higher recourse, under both the NAB and the GRA, on those who had not provided pre-NAB loans.

256 The G20 Working Group on International Financial Architecture, co-chaired by Australia and South Africa, had identified the need for an increase in Fund resources as a priority issue leading into the 2011 Cannes Summit.

own problems. Certainly, it would not be an easy sell to domestic constituencies.²⁵⁷ Equally, challenging domestic political environments were not unique to the US; China was preparing for a once in a decade transition of power to a new administration, significantly complicating its ability to engage on such issues. EME caution was to prove a particularly difficult hurdle in these negotiations.

The scope to reach an agreement in Washington in April 2012 was made possible by European announcements in March that year of a strengthened internal financial ‘firewall’ and policy response. Importantly, the announcement included an offer of €150 billion in additional resources to the Fund.²⁵⁸ Going into the April meetings, as Fund Management worked hard to lock in prospective commitments, on the understanding that these funds were for the whole membership, the key practical challenge was to manage the ‘first mover’ problem, with most who could

participate looking for significant company to provide the necessary political cover.

Once again, it was Japan — a country with an established track record of financial diplomacy, an appreciation of the benefits of showing leadership in this way, and a strong desire to protect its standing both in the region and globally — which was the first to go public on the eve of the April 2012 meetings with an offer of a bilateral borrowing agreement for up to \$60 billion. Over the following days, and with the active encouragement of Fund management and staff, a critical mass of announced contributions emerged. By April 20, Fund Managing Director Lagarde was able to announce commitments of \$430 billion, a figure that would grow further by the time of the Leaders’ meeting in Los Cabos. Of this, some \$362 billion had been publicly announced by the Euro Area and twelve other countries,²⁵⁹ while the remainder had been

257 Similar concerns were voiced by opposition parties in Australia, in a notable break with the traditional bi-partisan approach to issues regarding Australia’s membership of the IMF.

promised but not announced. The latter included unspecified contributions from Indonesia, Malaysia and Thailand — significant because of the continuing sensitivities about associating with the Fund in parts of Asia — as well as the BRICs.

The BRICs had, in some ways, been left behind by the momentum that had emerged to produce a tangible outcome at the meetings. Until the last minute, they had been seeking to maximize any leverage a contribution would provide to strengthen the commitment of others to delivering the agreed package of governance reforms. It was, however, unclear just what concrete signal they were looking for. In the end, it became apparent that BRIC soli-

arity on this tactic did not hold. In particular, while China had not been able to publicly announce a contribution, it had nonetheless made a commitment to Fund Management to participate. But the reluctance of China and some others to put their names to the package underscored the sensitivities and invariably eroded its signaling impact — as well as the leadership credentials of key players.

In the period since, the Fund membership has also been keen to demonstrate that there are limits to its acceptable exposure to Euro Area countries. The agreement in March 2012 to replace the 2010 Stand-By Arrangement (SBA) for Greece, which had established the expectation that the Fund would shoulder a third of the

258 In addition to the offer of funding for the IMF, the 30 March Statement of the Euro-Group included commitments to expedite the provision of capital to the European Stability Mechanism (ESM), the permanent funding facility for Euro Area countries facing liquidity difficulties, to change transitional arrangements as the ESM was to take over from the existing temporary facility, the European Financial Stability Facility (EFSF), and to bolster the combined lending ceiling of the EFSF/ESM from— 500 billion to — 700 billion through this transition period. While some continued to see a degree of smoke and mirrors in some of this, it allowed the Euro Group to claim it was putting in place an overall firewall of \$800 billion, in addition to the additional resources for the Fund.

259 Australia, Korea, Singapore and the UK chose to jointly announce their respective contributions, as a means of signalling that each was joining a collective international effort to buttress the global economy against the risks posed by the Euro Area's sovereign debt crisis.

external funding needed for Euro Area programs, with an Extended Fund Facility program was premised on the understanding that the Fund's peak exposure would be limited to that already agreed as part of the SBA. Greece's needs for additional funding would be met by additional European Union contributions and a haircut for private sector creditors.²⁶⁰ Subsequently, the Fund's share of financing the program for Cyprus announced in May 2013 was around a tenth of the total, significantly below the previously established benchmark.

The growing significance of emerging market economies as Fund creditors is clearly a significant development. In addition to their significant contribution to the NAB, and through ad hoc bilateral loans, emerging markets have progressively played a bigger role in funding the Fund's operations through the GRA.

The longer term implications for

the Fund's operations are yet to play out. However, early indications suggest that they are likely to bring an inherent caution to the management of the Fund's financial exposures.

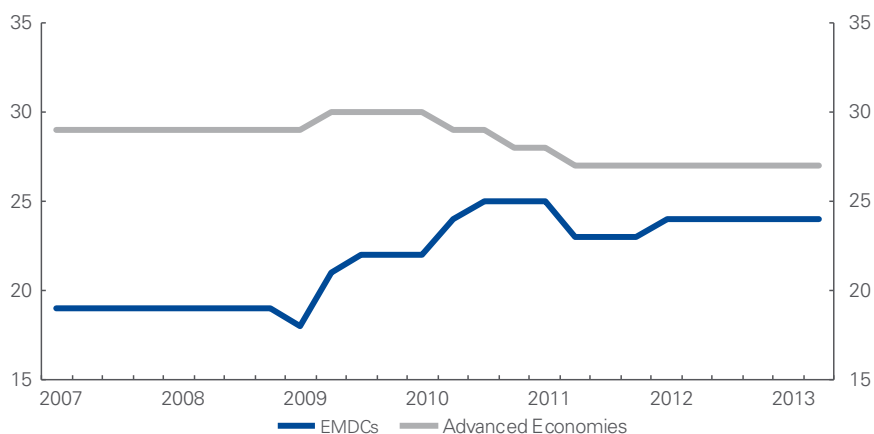
More fundamentally, the Fund's founding fathers' vision of a universal financial institution, in which all members at any point in time were potential creditors or users of Fund resources, seems no closer to reality. Indeed, the risk is for a greater operational compartmentalization of the membership to emerge, even if it is no longer based on the traditional advanced/emerging market and developing country dichotomy. Rather, it is likely to be based on a more complex combination of practical resourcing constraints, and domestic political sensitivities and caution as emerging markets manage the challenges of becoming significant creditors to the Fund. Notwithstanding the watershed use of Fund resources by some advanced economies, there remain a number of mem-

260 *IMF Executive Board Approves €28 Billion Arrangement Under Extended Fund Facility for Greece* Press Release No. 12/85, (March 15, 2012)

bers for whom this continues to be inconceivable. First among these is clearly the US, given its role as the primary reserve currency economy. It is equally hard to imagine the Fund having the resources to play a significant financing role should

liquidity challenges confront the larger advanced or emerging market economy members (in particular China, or even, say, India). And recent developments have demonstrated the extent to which domestic sensitivities across a

CHART IV-3: NUMBER OF COUNTRIES INVOLVED IN THE GENERAL RESOURCE ACCOUNT (BY COUNTRY TYPE)



Source: IMF Finance Department

wider range of key Fund members can be expected to constrain operational choices.

unlikely to change the fundamental nature of these dynamics any time soon.

Progress on governance reform may assist in managing these domestic sensitivities, but is

Certainly, resourcing issues are likely to remain inextricably bound up with the governance reform

agenda, which the experience to date suggests is at risk from growing reform fatigue. Progress on crucial issues such as how best to ensure the political engagement needed to ensure the Fund's effectiveness, alongside fulfillment of symbolically and substantially important commitments regarding the composition of the Executive Board and the appointment of senior leadership, is either non-existent or falls well short of the expectations created by the G20. On the core issue of quota shares, expectations have also been raised and significant agreements have been made, but they have yet to be delivered. The process is proving to be difficult with momentum hard to sustain. Perhaps most importantly, the almost continuous process of reviewing quotas risks embedding an underlying atmosphere of divisiveness among key players.

In principle, the alignment of quotas and voting shares with evolving economic realities should be a regular and continuing process. In practice, the forthcoming Fifteenth General Quota Review is likely to constitute the last opportunity for some while to effect

further realignment. Both the G20 and the IMFC consistently called for completion of the Fifteenth Review by January 2014, but this deadline has clearly been missed, and the US's continuing difficulties in delivering on the outcome of the Fourteenth Review remains the major threshold hurdle.²⁶¹ As noted earlier, the size of any increase under the Fifteenth Review will be central to the extent of feasible further realignment. In this regard, one might expect that the case for transforming the Los Cabos bilateral borrowing package — of which, by early June 2013, bilateral agreements totaling approximately three quarters of the announced total had been signed²⁶² — into a permanent increase in the size of the Fund will be harder to make.

On the broader elements of the governance reform agenda, the credibility of the commitment to meaningful changes in Board composition is at risk and will depend on the extent to which the spirit of the Gyeongju deal — a clear reduction in the European presence on the Board — can still be delivered. The next opportunity to demonstrate the broader

ownership of either the IMF or the World Bank in the selection of senior management is now some years away, but even with further shifts in voting shares in the interim, this will also need greater cohesiveness among the non-US/European members. And efforts to strengthen political engagement in the strategic oversight of the IMF are likely to remain problematic.

261 It is easy to imagine that Congress would be even less inclined to proceed with the approval of the US's increased quota under the 14th Review if it was conscious that discussions on the 15th Review were underway.

262 As of June 5, 2013, bilateral loan agreements have been concluded with Belgium, China, Denmark, Germany, Finland, France, Italy, Japan, Korea, Malta, Mexico, the Netherlands, New Zealand, Norway, Poland, Russia, Saudi Arabia and Sweden.

Section V

Concluding Observations

Effective international financial and economic governance remains crucial. However, we need to be realistic about its limits and inevitable imperfections. Over the last 6 years, we have seen international cooperation both at its best, at the height of the crisis, and at its most frustrating.

The track record of international cooperation on economic and financial issues in the period since the heady days of 2008-09 would seem to be increasingly one in which: 'successes', such as the agreement on a detailed agenda for financial sector reform or the Gyeongju package of governance reforms, have proven difficult to implement; proposals for grand reforms have met with consider-

able skepticism; sustained leadership has proven to be elusive; the value of international 'rules', in the absence of political commitment, has continued to be questionable, while their appeal appears to be largely defensive (of sovereignty); the scope for effective policy coordination between the main systemic players depends primarily on the fragile process of building trust and communication within the G20); and the prospects for continuing much needed governance reform appear compromised and tenuous.

Failure to live up to the high expectations established coming out of the 2009 Pittsburgh G20 Summit is in many ways testament to the realities of international

‘governance’. Sovereign states are under constant pressure to demonstrate to domestic constituencies how collective international action serves national interests. Just as the success of the 1944 Bretton Woods conference owed everything to the unique set of circumstances as the world emerged from World War II, providing a clean sheet of paper in a way not previously seen for a generation and certainly not seen since, so did the sense in late 2008 of imminent catastrophe, of the like not seen for 75 years, help concentrate minds. But sustaining a popular mandate for such collective action as the immediate risk of disaster receded was always going to be much harder.

In particular, as the focus, in areas such as policy coordination and financial sector reform, inevitably shifted from broad commitments to restore confidence, to more tangible questions of detailed implementation and the delivery of specific policy actions, the challenge of managing domestic sensitivities and trade-offs has come to the fore.

The financial crisis did not change these underlying dynamics, and the experience over the last four years has served to highlight the increasing difficulties of making progress in a multi-polar world.

The Bretton Woods governance model cleverly sought to acknowledge ‘real politic’ realities within a structure which ensured both the necessary leadership of key players and the legitimacy of voice for all. As legitimacy concerns have gathered momentum over recent years, in line with the failure of the Fund’s governance arrangements to keep up with shifts in relative economic weight, the foundations of the Fund’s effectiveness have also been weakened. More fundamentally, however, these shifts in relative economic weight, and the associated erosion of the US’s preeminent leadership role — the cornerstone of the system created at Bretton Woods — has itself also inevitably undermined effectiveness. While aligning formal voting shares with this new reality is essential for the credibility of the system, it does not resolve the underlying challenge

posed by a less asymmetrical and more dispersed distribution of influence among sovereign states. In this world, there are more players with the potential to veto collective action, while mustering and sustaining the leadership that is essential to advance any issue is more problematic.

One should be careful not to overstate claims of US decline. The US remains the world's dominant economy and indispensable power and is likely to remain thus for the foreseeable future. It has long enjoyed clear structural economic advantages, reflected in consistently strong productivity levels and an enviable ability to adapt to changing circumstances. These qualities are on display again as the pace of US economic recovery begins to pick up relative to other major advanced economies, notwithstanding the painful deleveraging process that inevitably impedes recovery from a financial crisis. The development of extensive shale oil resources will fundamentally shift the balance of power in the global energy market in the US's favor, with potentially

far reaching implications for both the US's economic, political and strategic relations. In political terms, the US retains a clear veto, and not just in the formal sense of its ability to block agreement on selected issues at the IMF. Progress on any issue, whether at the IMF or the G20, cannot be made if the US chooses to apply its weight and influence as a spoiler. US acquiescence, or at least its neutrality, is essential. And more than any other player, the US retains the capacity to shape the parameters within which an international consensus on issues of collective interest can be forged.

However, the US's relative dominance has clearly been eroded, a trend which is likely to continue. Moreover, the US preoccupation with its perceived decline is itself a source of uncertainty and ambiguity in the US's approach to global issues and only serves to strengthen tendencies to turn inward. Congress' recent failure to understand the importance of the IMF governance reforms to the US's enlightened self-interest is

testimony to this.

In terms of its underlying economic strengths, the US has emerged from the crisis facing significant challenges. Issues of medium to long term fiscal sustainability have been cast into sharper relief. Similarly, the sluggish recovery in employment and associated rise in long term unemployment threatens to further entrench increasing inequality. Such domestic concerns will invariably detract from, and in the case of fiscal sustainability issues can be expected to directly complicate, the domestic debate about the US's international economic leadership role.

Nor will a domestic political environment, which appears, at least to the casual outside observer, to be increasingly polarized and dysfunctional, likely be conducive to the exercise of sustained international leadership by the US. Efforts by the current administration to 'outsource' the US's pursuit of national security objectives in key parts of the world, and to scale back aspirations, can be

expected to have their corollary in the international economic sphere. The evident — and understandable — difficulties making a case for active US involvement in helping to finance and shape a sustainable solution to the current existential challenges confronting the Euro zone is a case in point. Congress's refusal to date to deliver the IMF's Fourteenth Quota Review and associated elements of the agreed governance reform package is the latest tangible evidence of this. The prospects for pursuing further reform in the context of the Fifteenth General Review of Quotas are diminishing rapidly.

The environment for pursuing the US's recently new found interest in 'economic statecraft' — an explicit recognition of the interdependence of foreign policy and national economic interests — is therefore an increasingly difficult one.²⁶³ Indeed, some have written of the challenge facing the US as it is forced to rediscover a 'national interest' based approach to foreign policy, as the post-cold war world gives way to a more complicated

263 See, e.g. Jennifer Harris, "Doubling Down on Economic Statecraft: What's at Stake for the United States and the World America Built," in Ian Bremmer and Douglas Rediker (eds), *What's Next: Essays on Geopolitics that Matter*, Portfolio/Penguin, New York, 2012.

set of international relationships and interests.²⁶⁴

Nevertheless, such concepts underscore the focus on anchoring international economic leadership overtly on concrete national interests. The primacy being given to major trade negotiations with Europe and the Asia Pacific by the current Administration is a good example of this — compared to arguably arcane issues such as the stability of the international monetary system, the domestic relevance of trade issues is relatively easy to understand and present in tangible ways. Equally, one can expect the US to continue to be very selective in terms of the ‘monetary system’ and policy coordination issues on which it chooses to engage, with a focus on those issues on which national interests can readily be defined and communicated; for example, the pursuit of bilateral exchange rate concerns.

Moreover, the US is likely to find it more difficult to navigate a careful path between national interest

— on which too heavy handed an approach may risk further damaging US leadership credibility and the legitimacy of the institutions through which it must operate — and the process of building a workable consensus with others on key issues.

However, predictions of an emerging new hegemony, as an alternative to US leadership, are also prone to overstatement. Post-second world war history has seen earlier examples of rising powers which, it was claimed, were destined to supplant the US, including at various times, Japan and the Euro Area. The sheer weight of China’s population and economic size, together with its remarkable economic growth performance of the last two decades, clearly suggest that it is a much more likely candidate to test US pre-eminence than either of these two contenders. The creation of supply chains that place China at the center of an integrated regional economy, with significant potential for their use in support of political goals, is a significant

264 Walter Russell Mead, “The End of History Ends” at <http://www.the-american-interest.com>, (December 2013)

development in the context of a n economy which continues to have a high degree of central political control. And the challenge of accommodating China's rise is made qualitatively more complex by the lack of shared political and social values.

Still, there remain many imponderables regarding China's capacity to harness its potential to underpin a sustainable rise in its global influence and power. It will need to manage significant pressures for structural economic and, eventually, political reform.²⁶⁵ There are genuine reasons to doubt that China can be as successful as the US in translating economic and military power into soft power. And commentators have noted the crucial importance of the next ten years in terms of China's new leadership team while also questioning whether a model which looks to the bureaucracy — merit based but inherently cautious — to identify each new generation of

leaders is well suited to producing the vision likely to be needed.²⁶⁶

In the context of the IMF/ G20, there are signs that China understands the challenge posed by Robert Zoellick, speaking as US Deputy Secretary of State in 2005,²⁶⁷ of stepping up to be a responsible stakeholder in the international arena. In this regard, one has the sense that the crisis itself was a catalyst for some internal re-evaluation of China's stake in multilateralism. Certainly, the quality of its representation has improved significantly over recent years — China's two Fund Executive Directors during the author's time on the IMF board have both been impressive individuals, respected by their peers for their ability to present their authorities' views on a wide range of issues in terms that are constructive and carefully nuanced. While clearly committed to the BRIC experiment, they have also notably been prepared to distance themselves,

265 Management of the process of capital account liberalization needed to underpin any ambitions for the Renmimbi to take on reserve currency status is likely to prove a particularly telling manifestation of this. The authorities will have to cede a degree of domestic control over domestic economic forces, as the price to be paid for broadening the China's international economic standing and influence.

266 See, e.g. Zhang Weiyang, "China must Seize Rare Chance for Reform", in *Financial Times*, March 7, 2013

267 Robert B. Zoellick, Remarks to National Committee on U.S.-China Relations, New York City September 21, 2005

at least in terms of tone, from the more strident views of some BRIC partners on potentially divisive issues.

Nevertheless, the track record also underscores a degree of caution and hesitancy in the exercise of its potential leadership role. Within the Chinese system, responsibility for membership of the IMF lies with the People's Bank of China (PBoC), an agency which leans towards support for market economics and domestic reform, but which has relatively limited clout in domestic policy debates. Awareness of, and interest in Fund related issues is reportedly relatively thinly spread beyond PBoC. This helps explain the reluctance to take a lead in exceptional financing packages put together for the Fund, first in 2009 and again in 2012. Difficulties of building a domestic consensus in favor of effectively helping to bail out more advanced economy members, and funding an institution in which it considered its voice was not given sufficient weight, were also no doubt relevant. It was clear that this challenge was made more

difficult as a result of the complexities and internal machinations of the recent domestic leadership transition. More generally, there is considerable anecdotal evidence to suggest that the almost byzantine machinery of China's internal decision making processes continues to compound the difficulties of reaching clear and proactive positions on issues. And there remains a tendency to fall back upon an excessively heavy handed approach to issues which are seen as directly relevant to China's national interests, as evidenced by China's recent efforts to dispense entirely with the World Bank's 'Doing Business' index, a tool which, while flawed, is nonetheless of potential systemic value to investors and to the international community as a whole.

Most importantly, it is almost definitely a mistake to think of China's evolving approach to exercising international influence in terms of some centrally determined, monolithic strategy. Notwithstanding China's fundamentally different political system, and a well-earned reputation for taking the long view,

the Chinese authorities are faced with the challenge of managing a range of complex and competing visions for its emerging power role. In many ways, this underpins the significantly more fluid, unpredictable and, indeed, dangerous world in which we currently live. But it also helps explain the caution that China brings to the table on many issues.

Equally, the BRICS grouping — of which China is the essential cornerstone — is still finding its way as a fully effective unified voice on international economic issues for emerging markets.²⁶⁸ Governance issues are clearly the centerpiece of their cooperation at the IMF. Indeed, there are suggestions that the protracted negotiations on the wording of the G20's Pittsburgh commitment on shifting quotas in favor of dynamic emerging market economies — which reportedly took several hours of US shuttle diplomacy between the BRIC representatives who had commandeered one room and the Europeans in another — was itself instrumental in cementing a com-

mitment to BRIC cooperation. In the years since, the machinery of cooperation has been enhanced, driven by regular leaders' summits. Communication between capitals on international economic issues has strengthened, alongside regular tactical cooperation at the IMF. Nevertheless, even on governance issues, there have been some notable differentiation of individual member's positions, for example China's willingness to signal a more pragmatic consensus driven approach to reaching an acceptable outcome on the recent quota formula review, or the initial resistance of some other members of the BRICS to the Executive Board's 2012 Integrated Surveillance Decision, which had been strongly championed by China. On governance issues, China, alone among the BRICS, has potentially ambivalent agendas — while it would be a winner from the agreed reforms, it is also well placed to take advantage of the US's failure to deliver. As mentioned earlier, it was apparent in the context of Fund Management's efforts to put together a

268 Among the BRICS, the latest addition, South Africa, is the most constrained in the Fund setting by its membership of a constituency of some twenty-two sub-Saharan African low income Fund members.

second round of bilateral borrowing arrangements in the lead up to the Los Cabos G20 summit that BRIC solidarity, in terms of efforts to leverage faster progress on governance reform, was strained.

Others have highlighted the inherent challenges of building an effective grouping from a convenient labeling of emerging markets with some common characteristics but equally many divergent interests.²⁶⁹ Brazil's recent efforts to test the WTO's capacity to deal with exchange rate issues are unlikely to have been seen as a helpful act by China, no matter the extent to which it may have been explained as targeting the US and quantitative easing. More generally, the shared strong growth performance which justified the label has, in recent years, come under pressure, as India struggles to maintain the momentum of market liberalizing reforms, Russia confronts the limitations of a growth model premised solely on high oil prices, and Brazil has progressively weakened the sound policy frameworks which

had underpinned its earlier sustained expansion. Recent mass political events in Brazil also underscore the challenges of managing expectations. Even for China, the jury remains out on the extent to which its predominant model of State Capitalism can continue to deliver the dynamism first unleashed by removing the constraints on private enterprise some two decades ago. The global adjustment challenges posed, first by the impact of the US Fed's extraordinary monetary easing and then by its subsequent unwinding, have only served to further highlight the BRICS divergent circumstances and interests.

In this context, Miles Kahler has emphasized the conservatism, and inherent circumspection regarding leadership, that emerging markets are likely to bring to the table, facing domestic challenges, including distributional conflicts that encourage risk aversion.²⁷⁰

Somewhat ironically, both at the Fund, and in the G20, the Europeans — earlier considered

269 E.G. Joseph Nye, *BRICS without Mortar*, available at www.project-syndicate.org/why-the-brics-will-not-work-by-joseph-s-nye, (April 2013)

270 Miles Kahler, "Rising Powers and Global Governance: Negotiating Change in a Resilient Status Quo," *International Affairs*, Volume 89, No 3, 2013.

a potential alternative to US international economic hegemony — are most organized in terms of shaping and prosecuting a common position. Well established coordination mechanisms are in place, matched by strong internal discipline. However, the Euro Area is clearly distracted by fundamental existential challenges, and has recently been most inclined to use its weight and influence largely defensively.

In such an environment of dispersed influence, a predilection for caution, and selective US leadership, the biggest risk is that of inertia. Ian Bremmer has very insightfully written of the challenges, and the ultimate unsustainability of what he has termed a G-zero world.²⁷¹ In looking at the forces likely to shape what might come next, as the world transitions to a more sustainable model, he constructs a set of possibilities built around two intersecting axes. Along one runs the degree to which China's and the US's interests are aligned or in conflict. Along the other one can map the

relative weakness or strength of other players. He characterizes the world represented by the four quadrants these axes create as, respectively, a G2 world (close alignment of Chinese and US interest, with all other players relatively unimportant), a concert of powers (US/Chinese alignment alongside other influential players), Cold War 2.0 (with the US and China dominant and in conflict) and a world of regions (US and China in conflict, among other influential players). For good reason, he is skeptical about the likelihood of a G2 world emerging — if only because it is not a model in which China has shown any interest. He is only moderately more optimistic about the prospects of an evolving concert of powers, but if we wish to nudge the world in that direction, an effective G20 will be essential.

In practice this will also need the constructive engagement of medium sized powers, such as Australia, the Republic of Korea, Mexico and Singapore. In recent times, these have often been the

271 Ian Bremmer, *Every Nation for Itself: Winners and Losers in a g-Zero World*, (Penguin, 2012)

players who, have helped forge the pragmatic compromises needed to underpin a continuing commitment, albeit one that may be less than wholehearted, to cooperation and collective action. These are the players who have arguably the most significant stake in making agreed norms of international engagement work, and in avoiding the other three quadrants sketched out by Bremmer.

What lessons should one take from this?

First, one should avoid grand visions for reform. There are good reasons why the Bretton Woods conference was a unique event in the last century, and the current environment is very unlikely to replicate such circumstances. Calls for ambitious reform are only likely to raise expectations that can't be met, further damaging the credibility of international economic governance. Rather, the cause of collective international action will likely need to rely on incremental, and sometimes second best, steps.

In the area of efforts to foster policy cooperation, those hankering after stronger rules would be better advised to focus instead on the painstaking process of building relations and trust between national officials, and fostering political ownership. The Fund's technical strengths and independence is likely to remain central to any effective policy dialogue, justifying continuing efforts to strengthen the quality of its analysis. Nevertheless, it is the G20 MAP and its successor process which has the greater potential to foster candid exchanges of views at the political level. The art to tapping this strength will lie in striking the right balance between the need to engage Leaders and Ministers in meaningful debate while not stretching the limits of participants' commitment to what must remain a voluntary process, well grounded in national interests and domestic agendas.

Nevertheless, it is important to press on with efforts to enhance the representation and voice of dynamic emerging economies at the IMF. A credible commitment

to ensuring that quota and voting shares regularly adjust to reflect evolving reality is essential to strengthening ownership of the Fund and its long term effectiveness. Again, however, one should acknowledge that this will most likely prove a slow and frustrating process. Agreement on a new quota formula, founded on first principles which all parties can support, is highly unlikely — the inherent politics will not conveniently disappear behind a veil of science! Potential winners and losers will each resist locking in a second best compromise, while attempting to preserve their bargaining position for future rounds. Instead, the process of re-alignment in quotas is likely to be a messy one, dependent on ad hoc political deal making. The Fifteenth General Review of Quotas, potentially offers the last chance for some time to make any further meaningful progress on this. Efforts to ensure the opportunity does not slip away are vital. Reinvigorating the legitimacy of the Fund, the core custodian of the shared values that underpinned

much of the post war economic prosperity, offers the best bulwark against a more anarchic global economic system — Bremmer’s world of regions’ — hostage solely to competing narrow national interests. Certainly, US interests would seem to be best served by such a strategy, even if the Congress seems to have lost sight of that.

On other aspects of Fund governance, and in particular the challenge of strengthening ministerial level engagement, progress is likely to remain largely stymied by caution, the deeply held suspicions of emerging powers, the political protection some see in the more technocratic processes of the Executive Board, and an overall sense of reform fatigue. If agreement on significant structural reform, such as the activation of a decision making Ministerial body to guide the Fund, was not possible in the immediate aftermath of the most significant crisis to threaten the global economy in the past seventy-five years, it is hard to see what might in the foreseeable future trigger a willingness to consider such reforms. More

fundamentally, in a world in which the legitimacy of ‘rules’ based approaches have been progressively eroded, the rejection of the Council is easy to understand. The multipolar world does not easily lend itself to formalized decision making processes.

Efforts should continue to enhance the effectiveness of the IMFC as a forum for political ownership of the Fund, and the process of policy coordination more generally. In addition to the initiatives made to date to improve the opportunities for confidential and candid exchange between participants, it would be worth thinking further about an expanded role for Deputies (i.e. senior officials) in shaping the IMFC’s agenda, something which is currently largely in the control of IMF Management and the Chair, albeit with a formal but largely marginal role for the Executive Board. However, any such suggestions would need to overcome likely resistance from both Fund management and the Board — the latter driven by a sense of its own importance

but also by those who look to the Board’s consensus driven, technocratic approach to provide protection on sensitive issues. Such reform efforts will therefore probably continue to fall short.

Instead, it is likely that the legitimacy offered by the Fund’s formal structures and universal membership will continue to need to be buttressed by the role of the G20 in providing political ownership, implying a continuation of the uncomfortable, but nonetheless complementary, partnership that has evolved between the two.

This will require acknowledgement that the G20 too faces significant challenges if it is to remain effective and relevant, and respond to criticisms that it has lost its way since its early successes at the height of the crisis.

Commentators²⁷² have highlighted the risks relating to an ever expanding agenda, as each new Chair adds new issues without feeling able to trim those it has inherited. This has been associated

272 E.G. see Mike Callaghan, *Relaunching the G20*, Lowy Institute for International Policy, January 2013

with a seemingly exponential growth in reports and recommendations commissioned by the G20, and related difficulties in sustaining the engagement by Leaders, the core pillar of the G20's effectiveness. It has also compounded the difficulties of ensuring clear communication of the G20's objectives and outcomes. And it has arguably seen the G20 become distracted from a core focus on macro-economic policy cooperation. Meanwhile, the pressure of identifying tangible outcomes for each Summit brings with it an increasing risk that those announced cannot be delivered. An honest and open exchange between members, aimed at reaching a common understanding of these problems and agreeing solutions, for example, finding alternative mechanisms for progressing much of the legacy 'technical level' agenda, much of which is valuable but which risks overwhelming the demands on Leaders, will be essential.

The MAP and its subsequent incarnation must stay at the core of the

G20's work program. A balance will have to be struck between the tyranny of 'deliverables' and the more subtle value in fostering candid and open exchange between Ministers and Leaders. On some sensitive economic policy concerns — e.g. currency wars — the quest for tangible public outcomes may prove unhelpful. A focus on a realistic but suitably ambitious collective growth agenda may offer a way forward, albeit while treading carefully with regard to its growing focus on structural policies, on which the interface with domestic interests will potentially be more confronting.²⁷³

The G20 enjoys one significant and essential advantage over its predecessor, the G7, in that it brings the right countries together. However, it suffers a number of relative disadvantages. These include: those associated with its larger and more diverse membership, including differences in political and institutional systems which contribute to inflexible and/or impenetrable domestic decision making and complicate the

273 There are encouraging signs that the Australian Presidency has engaged the membership on just such a process, avoiding adding new agenda items and focusing of the existing agenda items more sharply on a select number of practical outcomes.

challenge of fostering a collegial network of officials; related to that, the relatively limited capacity of some G20 members to engage on issues; and, as discussed above, the inherent suspicion and defensiveness that a number of the expanded membership bring to the table on many issues.

By definition, the G20 reflects the multi-polar world we live in and embodies many of its challenges. If it is to be the solution and not just a manifestation of the problem, it is essential we do our best to make it work. Bremmer does not attach a high probability to the likelihood that we will transition from what he calls the G-zero world into his 'Concert of Nations' quadrant. Nonetheless,

an effective G20 represents the best chance of nudging the transition in that direction. It will require realistic expectations, while building confidence and trust through measured, pragmatic steps. This is not an especially inspiring rallying cry on which to conclude! However, accepting the inherent fragility of international governance arrangements is an essential pre-requisite to making them work and building a stronger foundation over time.

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From late 2008 through 2012, Chris Legg served on the Executive Board of the International Monetary Fund, first as Alternate Executive Director and then, from November 2010, as Executive Director for the Asia and the Pacific constituency, representing 14 countries (Australia, Kiribati, the Republic of Korea, Marshall Islands, the Federated States of Micronesia, Mongolia, New Zealand, Palau, Papua New Guinea, Samoa, the Seychelles, the Solomon Islands, Tuvalu, Uzbekistan and Vanuatu). He had

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