Emerging Powers and Global Governance: Whither the IMF?

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SUMMARY:

1. The centre of gravity of the global economy is shifting back towards Asia from the North Atlantic. This change however, is not reflected in the framework of global economic governance.

2. International finance organisations remain dominated by advanced economies resulting in the creation of new institutions led by emerging and developing economies, particularly by the BRICS, such as AIIB, BRICS New Development Bank, and the Currency Reserve Arrangement (CRA).

3. Emerging economies are currently experiencing a slowdown, due to the downturn in oil and commodity prices. In order to return to a path of sustained growth, appropriate policy reforms need to be taken.

4. Excessively accommodative monetary policies have led to the existence of large debt overhangs in advanced and emerging markets.

5. As international financial markets have become more interconnected, resolution of financial and balance of payments crises need large international resources. Thus, the case for the existence of the IMF can be made, however, it needs to be adequately resourced.

6. The IMF must have adequate and permanent quota resources to retain and enhance its credibility and legitimacy.

7. Quota resources can be increased regularly corresponding to the expanding size of the global economy and financial markets. Regular quota reviews will also ensure that emerging powers get their rightful share in the IMF's governance.

8. The IMF governance structure needs to become more inclusive – the informal agreement that the IMF must be headed by a European national must to revisited to allow other nationalities to be given a fair chance.

The world is at the cusp of an epochal change in global economic power, unprecedented over the past 200-250 years since the start of the industrial revolution.

After more than 200 years the centre of gravity of the global economy is shifting back towards Asia from the North Atlantic. Yet there is little evidence of this change being reflected in the framework of global economic governance, where we see little substantive change in the governance of the international financial institutions, like International Monetary Fund and the World Bank. The five-year delay experienced in ratification by the United States Congress of the 2010 reforms of the IMF indicates some degree of reluctance by advanced economies to countenance broader governance changes, despite these momentous economic shifts.

The international financial organisations remain dominated by the advanced economies. IMF reforms were held up until December 2015 by the US administration's inability to obtain approval from Congress for doubling the IMF's quota resources, and changes in its voting and quota structures that the IMF's board of governors agreed under the 2010 review process (the Fund's 14th).

This congressional blockage was doubly unfortunate because the US was the principal architect of the 2010 accord. The US has 17.7 percent of IMF quota shares and hence an effective veto over important decisions that require a 'super-majority' of 85 percent.

The creation of new institutions led by emerging and developing economies, particularly by the Brics countries (Brazil, Russia, India, China and South Africa), such as the AIIB, the Brics New Development Bank and Currency Reserve Arrangement (CRA), is indicative of these countries' dissatisfaction with the current framework. Prospective changes in quotas and voting shares would lead to reduction in the shares of the European countries, which retain disproportionate weights in the IMF despite their shrinking share of the world economy. US leadership of the international institutions remains of great value, and it is important that, among the advanced economies, the US retains its dominant position. The Bretton Woods institutions owe their founding to US vision after the Second World War. US financial markets continue to be the most dominant in depth and efficiency – and the dollar is still the world's dominant reserve currency and will remain so for the foreseeable future. Although the role of the emerging economic powers is increasing, their soft power is not rising at the same pace, underlining the importance of maintaining US leadership.

Economic Weight Shifts

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

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

The share of emerging and developing economies in global GDP is expected to increase from 40 percent in 2000 to over 60 percent by 2020 in purchasing power parity terms and from 20 to 40 percent in market exchange rate terms. The share of G7 countries in global GDP (PPP) is expected to fall from about 44 percent in 2000 to about 30 percent by 2020, with a corresponding increase in the share of Brics from 19 percent in 2000 to 33 percent in 2020 – part of much bigger changes expected up to 2060.

The emerging economies' demand for better representation must be seen against the backdrop of the North Atlantic financial crisis that originated with US sub-prime troubles in mid-2007. The crisis has led to stagnation and weakness in the mature economies, whereas emerging economies recorded strong growth until recently. Emerging economies are no doubt experiencing a significant slowdown at present, some due to the downturn in oil and commodity prices, and others due to the surfacing of unaddressed structural problems. It remains to be seen when these economies will return to a path of sustained growth, which is certainly feasible given appropriate policy reforms.

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

Financial globalisation is unlikely to be reversed. As the world recovers from the 2008-09 turbulence, other crises will erupt. We have already seen the global impact of the current difficulties being experienced in the Chinese capital markets.

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

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

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

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

The IMF's governance structure has to become more inclusive. The US needs to retain its role, in its own as well as the wider international interest. As US Treasury Secretary Jack Lew noted in March 2015: 'A well-resourced and effective IMF is indispensable to achieving our economic and national security interests, protecting the health of the US economy, and enhancing the prosperity of America's workers.'

European countries remain overweight, with the 'advanced Europe' group (European Union, Norway and Switzerland) taking a third of board seats, and more than a third of board voting power: the relative constancy of their quota shares is striking, since their share in GDP is falling consistently. Furthermore, the Bretton Woods institutions since inception have been headed by European nationals in the IMF and US nationals in the World Bank. This pattern has continued for almost seven decades now. There has been an informal agreement that the World Bank would be headed by a US national, while the IMF would be headed by a European.

Thus, nationality has turned out to be the guiding criterion to head the Bretton Woods organisations and nationals of other countries, irrespective of their merit, have been excluded from the process. This must be corrected. Other institutions such as the World Trade Organisation have already shown the way; there is no reason why the Fund in coming years cannot find procedures that could result in the same outcome.

US Needs to Retake Leadership

Global economic governance is at a crossroads. The global economy has become much more complex and interconnected, as international trade has become virtually free across the board as a consequence of the successive multilateral trade rounds, and as capital accounts become more open.

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

If the US believes that the IMF is important for the smooth functioning of the global economy, in which it has a large stake, it must make it clear that it is in favour of discussions on and consequent approval of the next five-year review (the 15th), which should in normal circumstances have been approved by end of 2015. And the US should support other such quota reviews in the years and decades to come.

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

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

2013 data, would be 14.5 percent , compared with 27.6 percent for the EU (based on the current quota formula).

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

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