

## Learning from the Crisis: Where do we go for Global Governance?

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### **ECONOMIC TRANSFORMATION AND MULTILATERAL REFORM: The BW Institutions and the G7**

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Over the past half century the world economy has become increasingly interdependent. Developments in the economy of one country or region are transmitted to other countries through high levels of international trade and financial flows. This integration differs from the patterns of a century ago in that a growing number of multi-national firms have spread their production processes over a number of countries. As a result intra- firm trade and intra-industry trade have risen sharply as a proportion of international trade. Developments in information technology have erased distances and the integration of capital markets has proceeded to essentially create a single international capital market. The volume of financial transactions has grown exponentially and currently greatly exceeds the volume of flows in trade of goods and services. The close integration of the global economy presents new and difficult economic challenges.

The transformation of the global economy has not been matched by a parallel evolution of the mechanisms and institutions of global economic governance. The current government structure of the World Bank and the IMF is the result of a political settlement at the Bretton Woods Conference in 1944.

The initial distribution of power, as determined by the President and the Secretary of State of the US, was to give “the big four” allies of WWII the largest quotas. The formula designed to meet this political objective was to give the US the largest quota, about a third of the total,

the British Empire a quota about half that of the US, the Soviet Union a quota smaller than the British and China a quota smaller than the Soviet one.<sup>1</sup>

The formula was politically determined and was never representative of economic size of economies. Moreover, since it does not reflect the changes that have taken place in the world economy since then, it is backward looking. The present structure is not representative and bears little relation to the size and importance of the economies of the member countries in terms of GDP, population, share of world trade, reserves or of their ability to contribute financial resources. This inadequate representation of their membership undermines the credibility and legitimacy of the two institutions<sup>2</sup>.

Some of the most important changes that have taken place in the world economy since 1944 include the following:

1. The US which was the only large capital surplus country up to the sixties, and thus the main provider of resources for the IMF and World Bank, has become a net debtor as its external liabilities exceed its assets abroad and today is the world's the largest debtor country.
2. The European countries proceeded to form a Common Market, which was later to become the European Union. European countries have introduced a common currency, but the voting shares of countries in the Euro area were not adjusted to reflect this change. According to the 1944 Bretton Woods formulas, international trade is a major factor in the determination of IMF quotas. This resulted in the members of the EU having 74 percent greater voting power than the US despite having a smaller GDP.
3. The G7 industrial countries which have effective control of the IMF and World Bank represent less than 14 percent of the world population and accounted for 44 percent of world output in 2002. The developing countries and economies in transition account for some 84 per cent of the world's population and the same proportion of world output as the developed countries measured in terms of purchasing power

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<sup>1</sup> The **ad hoc** formula was: 2% of national income,-later GDP-, 5% of gold and dollar holdings, 10% of average imports, 10% of the maximum variation in exports, and the last three variables to be increased by the ratio of average exports/national income. Combined with 4 others, with variations to the weights of these variables, the formula is still in use. Discretion is used as to the formula to be applied in each case.

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parity<sup>3</sup>. For this reason, decisions taken by the G7 countries without the participation of the major developing countries are often ineffective and perceived as having limited legitimacy.

4. The developing countries have registered higher GDP growth rates than the industrial countries and have increased their share of world GDP, measured in terms of PPP from 30 percent in 1950 to 39 percent in 2002 and to 44.2 percent, if economies in transition are included.<sup>4</sup> The developing countries have increased their share of world exports from 26 percent in 1972 to 37 percent in 2002.<sup>5</sup> Particularly noteworthy is the rise of output in Asian economies-excluding Japan- which accounted for only 9 percent of world output in 1950 and today represents almost 23 percent of global GDP, rather more than the US.<sup>6</sup>
5. The volume of reserves held by developing countries has risen from SDR 33.3 billion in 1972 to SDR1.131 trillion at the end of 2002, and greatly exceeds that of the industrial countries SDR 749 billion on the same date. The reserves of Asian countries showed an extraordinary increase from SDR 7.9 billion in 1972 to SDR 720.1 billion in 2002.
6. Middle income countries, which account for 10 percent of world GDP are projected to reach about 33 percent by 2025 using the framework developed by Kremer, Onatski and Stock (2001). This result is robust to a number of alternative assumptions. For example it does not depend exclusively on the likely transition of China and India to a higher income bracket. Performing the same exercise for a group of countries that excludes China and India yields an increase in emerging markets share of GDP from 11 to 25 percent of world income.
7. Dynamic change continues, according to a study by Goldman Sachs,<sup>7</sup> over the next 50 years, Brazil, Russia, India and China could become a much larger force in the world economy, larger than the G-6 in US dollar terms. By 2025 they could account for over half the size of the G-6. Currently they are less than 15%. Of the current G6, only

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<sup>3 2</sup> Developing countries alone account for over 39% of world GDP. Source IMF, WEO data base.

<sup>4 3</sup> World Development Indicators 2003, World Bank

<sup>5 4</sup> IFS Yearbook, IMF

<sup>6 5</sup> World Development Indicators 2003, World Bank

<sup>7 6</sup> See "Dreaming with BRICs, The path to 2050", Global Economics Paper No.99, 1<sup>st</sup> Oct.2003

<sup>7</sup> Op. cit.

Japan and the US would be among the six largest economies. As early as 2009, the annual increase in US dollar spending from the BRICs could be larger than the G-6 and more than twice what it is now in dollar terms.

8. Demographic trends are likely to exert a growing influence on the international economy. Demographic growth in poor countries is likely to result in a growing share of world GDP in emerging markets, particularly in Asia at the expense of major industrial countries. Moreover, population projections by the UN show that aging of population in industrial countries is likely to have major consequences on the world economy, including a decline in saving and growth rates in advanced economies as public and private spending on health services rises sharply.

The growing breach between the distribution of world economic and financial realities, -including the distribution of world population- and the governance structure of the multilateral institutions, and in particular of those with weighted voting, like the Bretton Woods institutions makes reform necessary to enhance their effectiveness and restore their legitimacy. Enhancing the participation of developing countries in the solution of the major problems confronting the world economy in money and finance, would improve global economic performance in terms of securing a more effective international adjustment process, fuller utilization of global resources, higher rates of growth and employment, greater macroeconomic stability for emerging markets and primary producer countries subject to commodity shocks, and contribute to the elimination of world poverty.<sup>8</sup>

## II- Towards Multilateral Reform:

As we continue to move towards a world distribution of production and population that is very different from those prevailing only twenty five years ago or even that of today, we face a problem that arises because of the inconsistency between economic decisions that reflect the present, and backward looking governance structures that reflect the realities of the middle of last century. This leads to a loss of representativeness and legitimacy. As the institutions are seen as serving the interests of a small group of countries and reflecting an obsolete power structure, they are increasingly dysfunctional. To be effective, decisions must be based on current realities and can no longer be taken by a small group. To be legitimate,

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<sup>8</sup> For an explanation of this point, see paper by Buirra “Can a More Representative Governance Improve Global Economic Performance” at <http://www.g24.org/001gva04.pdf>

decisions affecting the international community must be taken by a broader, more representative body, that reflects the current economic and political situation.

If the governance structures of the BW institutions are not able to change, they will simply be left behind while new, most likely, regional institutions take their place. They will first appear in Asia in the monetary and financial field because of its high levels of savings, and because Asia has already moved away from the IMF and is increasingly moving away from the World Bank. The Chiang Mai initiative to pool reserves and recent measures for the development of a regional market for bonds denominated in domestic currencies are significant steps in that direction. As these arrangements and regional trade grow in strength, the adoption of a common currency may be considered.

As Argentina and Brazil recover, Latin America may be expected to follow. While Mercosur develops as a block and the Andean institutions for economic and monetary cooperation gain strength, both groupings will link up with each other. The writing is on the wall. These trends may spell the end of the current multilateral system.

Already, a number of emerging economies and middle income countries (Brazil, China, India, Korea, and Mexico) are among the largest economies in the world, they exert considerable economic and political regional influence, and as debtors are too big to fail; therefore they can exert significant leverage over the IMF and World Bank and the international financial system.

Since 1973 the members of the G7 have met informally and set the agenda for the international economy. For this purpose they have used their control over institutions like the IMF, the World Bank and the OECD. But the multiplication of economic actors and the changing balance of economic and political power makes this way of operating increasingly ineffective. Hence the need to broaden the group, to take into account changes in the world economy and to bring new players into the decision making process is increasingly recognized. Recent suggestions that China be invited to join the G-8 or the G4 in order to allow it to deal more effectively with the global payments imbalances and the realignment of the exchange rates of key currencies are an example of this trend.

The abandonment by the US, of the G10 Finance Ministers and/or Bank Governors, as a forum for international economic coordination and decision making, condemned it to

irrelevance.<sup>9</sup> The formation of the more representative Willard Group, which was shortly replaced by the G-20 Finance Ministers of “systemically significant” countries can be seen as a recognition of the lack of representativity of the Executive Board of the Fund as well as an additional manifestation of the need to be more inclusive in order to manage certain financial issues effectively. It may also reflect a need for greater representativeness and legitimacy in decision making. Another instance is the recommendation, contained in the Zedillo Report to the Secretary General of the UN, for the formation of an Economic Security Council that would oversee the problems of the global economy. That the discussion of this proposal in the Conference on Financing for Development was resisted by all G7 countries except France, illustrates their reluctance to give up control over the Bretton Woods institutions. Since then the UK has come out in support of this idea.

### III Current Prospects for Reform

Current IMF quotas and voting power are not representative of the size of the member countries economies, as may be seen in Table 1, which shows that the EU of 15 members has some 73% greater voting power than the US, despite a smaller GDP.

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<sup>9</sup> The G10 includes the G7 and some smaller industrial countries such as Belgium, Netherlands and Sweden. There seems to be no reason for its continued existence.

**Table 1. Quotas and Voting Power of Selected Industrial Countries in 2000**

	GNI <sup>1</sup> (PPP)	GNI <sup>1</sup> (billion \$) at market exchange rates	IMF Quotas (million SDRs)	Votes	As a % of total
European Union	<u>8,864</u>	<u>8,459.4</u>	<u>64,339.5</u>	<u>647,145</u>	(29.8%)
of which:					
France	1,438	1,438.3	10,738.5	107,635	
Germany	2,047	2,063.7	13,008.2	130,332	
Italy	1,354	1,163.2	7,055.5	70,805	
United Kingdom	1,407	1,459.5	10,738.5	107,635	
Other members	2,618	2,334.7	22,798.8	230,738	
United States	<u>9,601</u>	<u>9,601.5</u>	<u>37,149.3</u>	<u>371,743</u>	(17.1%)

*Memorandum Items*

World	44,459	31,315	212,666	2,172,350	
All Industrial Countries	24,793	24,994	130,567	1,347,885	(62%)
Developing Countries and Transition Economies	19,666	6,321	82,099	824,465	(38%)

<sup>1/</sup> In 2000

Source: World Bank, *World Development Indicators*, 2002. *IMF Survey Supplement*, September 2002.

**Table 2: IMF Quotas and Gross Domestic Products for Selected Countries**

Country	Quota as of		Share of World	
	December 31, 2002		GDP 2002	
	Billions of Special Drawing Rights	As a proportion of total quotas	Measured in PPP terms	GDP Converted at market exchange rates
Canada	6,369	2.99	2.01	728
China, People's Rep. of	6,369	2.99	12.67	1,237
Russian Federation	5,945	2.79	2.68	346
Netherlands	5,162	2.43	0.88	449
Belgium	4,607	2.16	0.59	247

Switzerland	3,458	1.63	0.45	268
Brazil	3,036	1.43	2.63	448
Mexico	2,586	1.22	1.90	642
Denmark	1,643	0.77	0.33	172
Korea, Republic of	1,634	0.77	1.78	462

Table 2 illustrates the prevailing situation where the quotas of say, Brazil, Mexico are smaller than those of the Netherlands, Belgium, and Switzerland despite having larger economies. The relation between the GDPs and quotas of Denmark and Korea or of China and Canada, which further illustrate the non-representative character of current IMF quotas and voting power.

In addition, a major adjustment in European quotas seems necessary to reflect their adoption of a single currency. When the calculated quotas of members of the Euro-zone are adjusted for the fact that trade within the single currency area is no different than trade within a single country, in that it can not give rise to payments imbalances, their share of total quotas falls by 40 percent. The adjustment in the European quotas would by itself, create enough room to increase developing country quota share significantly and thereby improve developing country representation.

**Table 3. Current and Adjusted Calculated Quota for the EU-12 countries<sup>10</sup>**

	<b>Current Calculated Quota (in millions SDR)</b>	<b>Share (in percent)</b>	<b>Adjusted Calculated Quota (excluding intra-trade in good and services) (in millions SDR)</b>	<b>Share (in percent)</b>
<b>EU-12</b>	<b>234,860</b>	<b>28.3</b>	<b>120,926</b>	<b>16.9</b>
Austria	9,572	1.2	4,177	0.5
Belgium	17,709	2.1	6,649	0.8
Finland	4,955	0.6	2,592	0.3
France	38,652	4.7	21,593	2.6
Germany	62,854	7.6	34,872	4.2
Greece	3,087	0.4	2,031	0.2
Ireland	9,323	1.1	6,494	0.8
Italy	30,286	3.6	17,407	2.1
Luxembourg	12,903	1.6	3,580	0.4

<sup>10</sup> OECD data on services was converted to SDRs at the average rate for each year taken from IFS. Calculations by the G24 Secretariat

Netherlands	24,562	3.0	10,990	1.3
Portugal	4,433	0.5	1,844	0.2
Spain	16,522	2.0	8,697	1.0
<b>United States</b>	<b>138,060</b>	<b>16.6</b>	<b>138,060</b>	<b>19.3</b>
<b>Japan</b>	<b>70,364</b>	<b>8.5</b>	<b>70,364</b>	<b>9.8</b>
<b>Other countries</b>	<b>387,271</b>	<b>46.6</b>	<b>387,271</b>	<b>54.0</b>
<b>Total</b>	<b>830,556</b>	<b>100.0</b>	<b>716,622</b>	<b>100.0</b>

Note decisions on all important (53) subjects require **special majorities**. Decisions on 18 subjects require 85% of the vote, which gives the US veto power. Decisions on 21 subjects require 70% of the vote; the G-5 has 39.6%. The combination of weighted voting plus special majorities results in a concentration of power in a few countries that can not be justified and makes the reform of the power structure indispensable if not urgent. At present, there is no accountability for decisions made, therefore, the current governance structure is widely seen as lacking legitimacy.

At the intellectual level the argument for reform of the governance of the Bretton Woods institutions is largely won. It is now generally accepted by industrial countries that developing countries are under-represented and that current voting power does not reflect the evolution of the world economy and in particular, that of the more dynamic economies. Nevertheless, there are strong vested interests in preserving the status quo that benefits the few. The defensive attitude of the smaller European countries that stand to lose a seat at the Board is noteworthy, and can be illustrated by the letter from the Finance Minister of a small EU country to the Chairman of the Development Cttee. which reads as follows:

“ I do agree with you that this issue,(of governance) which remains a major challenge, is of particular importance to the development community as a whole and that it needs to be addressed.

While I recognize that more progress will have to be realized between now and the 2004 Annual Meeting, one has to acknowledge what has been achieved so far. As you mention in your letter, the Boards of the Bretton Woods institutions have initiated steps to strengthen capacity in the offices of the two African Executive Directors, to promote the use of communications technologies to enhance dialogue between Washington and capitals. A new Analytical Trust Fund and a Secondment Program are being established. In this respect, I am pleased to inform you that (name of country) is considering a contribution to the financing of the Secondment program.

One should strive to make further progress while remaining pragmatic and realistic. It would serve little purpose to pursue avenues that may turn out to be dead ends. Furthermore, the establishment of an independent "Eminent Persons' Group" to consider the composition, structure and functioning of the Boards may ultimately contribute to blur the issue. I would therefore entrust the Boards to reflect further on the issue, to look for additional "quick wins", and to report to us at the 2004 Annual Meeting."

Note the letter centers on administrative measures of limited scope and carefully avoids making any reference to the central issues of increasing basic votes or reviewing current quotas, which are at the center of the discussion, and constitute the essence of, increasing developing country representation. Note also the preference for leaving the study of reform proposals in the hands of the Boards, where weighted voting allows the preservation of the "status quo".

Thus, given that under the present distribution of voting power which gives an assured majority to industrial countries, this group of countries can not be out voted, the road for the implementation of reform appears to be a long one. The adoption of the European Constitution, which calls for a single European representative in all international organizations offers a possible way forward. If the European Constitution, were accepted by all European governments this year, it may open the way for reform. But it may take several years for the Constitution to be ratified by the parliaments of all member countries before coming into force. Nevertheless, this may be best way forward.

Another, less likely possibility, is that the larger European countries that take a more positive attitude towards governance reform, and/or the US put pressure on the smaller European countries to come together in a constituency. The Benelux, the Nordic countries and Switzerland, which today hold four chairs at the Executive Boards, would be good candidates for a joint representation. A regrouping and consolidation of smaller countries in fewer chairs would require considerable political pressure from the larger countries and the developing countries. However, the larger European countries do not seem prepared to press them for the sake of an increasing developing country representation. This consolidation will not happen unless the example is set by the larger EU countries say, France and Germany, coming together in a joint constituency.

The US has not encouraged Europe to reduce its overrepresentation, nor in any way favored the reform of the BWIs governance, despite its obvious lack of representativeness. They seem to take the view, however shortsighted, that the current system that gives them and other industrial countries assured control in decision-making, suits their purposes.

Can developing countries themselves change the composition of the Executive Boards by not voting for developed country representatives in the election of EDs? Since many are grouped with industrial countries, and thereby lose their vote on all issues where there is a conflict of interest with industrial countries, this would make sense. It would increase developing country voting power of EDs representing developing countries at the Board by some 7.85,<sup>11</sup> percent and would reduce that of industrial countries' EDs by the same measure. The difficulty would be to persuade some small countries that receive technical or financial assistance from the industrial country that represents them, to move to a developing country constituency, as they may not wish to put that support in jeopardy.

Not surprisingly, there is a growing perception, including among IMF senior staff,<sup>12</sup> that the current governance of the IMF and World Bank requires reform. The recent appointment of the new Managing Director of the IMF, represented a small step in the direction of governance reform. Recall that the Draft Report of a Joint Working Group of the Boards of the IMF and World Bank, on the appointment of the heads of the institutions, of April 25, 2001. The report established a procedure to be followed in future, by which:

--Executive Directors should be informed in a timely manner regarding candidates, including their credentials and knowledge of the institution;

--all members of the Executive Board should be consulted in the process of considering candidates that leads to the selection of the Managing Director; and

--a plurality of candidates representing the diversity of members across regions would be in the best interests of the Fund; the goal is to attract the best candidates regardless of nationality.

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<sup>11</sup>10 Including the constituency currently headed by a Spanish ED. If that is excluded, the figure falls to 3.6%

<sup>12</sup><sup>11</sup> i.e. March 25 letter to all staff members by Jack Boorman, former Director of PDR Dept. and Counsellor to the MD, which was widely supported.

Thus, the selection process would be participatory, open to candidates from all regions of the world; and the selection would be based on their merits, regardless of nationality.

The unexpected resignation of Horst Koehler as MD and the rapid European move to select his successor without consultation gave rise to a statement by 14 EDs representing 126 members, mostly developing countries, recalling the agreed procedure and challenging the assumption that Europe could select the next MD. This posed a difficult problem for Gordon Brown, who as Chairman of the IMFC was charged with finding a candidate that could command consensus. A Spaniard, a Frenchman and an Egyptian candidate were put forward. As a majority of European members favored Rodrigo Rato, the French candidate withdrew. Thus for the first time, two candidates went forward before the Board for the consideration of EDs, and although a European national was elected, a precedent was established that should apply in the appointment of the World Bank President next year.

Of course, the problem of global economic governance extends well beyond the BW institutions. The G7 itself is increasingly seen as a self appointed group of international creditors, unrepresentative of the international community at large. Therefore, its recommendations lack legitimacy, and decisions of its members, accounting for under half of world GDP measured in PPP terms, are often ineffective. An example of this was provided by the recent meeting of the G7 Finance Ministers at Boca Raton to discuss exchange rates and global payments imbalances; by excluding China and other Asian countries, the meeting was condemned to irrelevance.

The timely G20 initiative by the Canadian Prime Minister is not the only manifestation of prevailing dissatisfaction and unease with the G7, nor the only recent proposal to move away from the G7/8 to a wider, more representative body, but one that is nevertheless, small enough to be effective.

In a report “International Economic and Financial Cooperation: New Issues, New Actors, New Responses”<sup>13</sup> by Peter B. Kennen, Jeffrey R Shaffer, Nigel L. Wicks and Charles Wyplosz, the authors recommend the formation of a new Council for Financial and Economic Cooperation (CIFEC) as “an agenda setting body that provides strategic direction for the functioning and development of the international financial system.” The number of

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<sup>13</sup> Presented in Geneva on May 7, 2004, to be released in September 2004

15 members proposed, is considered small enough to foster candid discussion and generate consensus.

In this view, the Council would have to include among its membership the governments of those countries whose actions have a greater impact on the international economic and financial system. Legitimacy and representativeness require that the Council be widely regarded as being responsive to the needs and concerns of the whole international community. <sup>14</sup>This body would make its recommendations in the same way the G7 does now- by issuing communiqués. It would not be able to instruct any other international body. Its influence would depend on the on the character and cohesion of its own membership. But if it included countries that play a leading role in international organizations and its recommendations reflected the consensus of its membership, it could expect its members to support its views in other bodies, and thus to exert a major influence on their policies and decisions.

How are the members of this group to be chosen? It is suggested that when the Euro zone is treated as a single unit it join the US and China in the first ten country group, regardless of the measure used to weigh economic importance, (GDP or exports + imports) and only five other countries appear uniformly in the list of first ten-country group: Brazil, India, Japan, Mexico and the UK. The economic data presented would fully justify the addition of Canada to this group. The authors of this report suggest a core membership of five permanent members and ten rotating members, but acknowledge that if it were decided that all members be permanent, their number should be increased.

Recall also that in order to avoid the perception of the G7 as a self-appointed Directoire, President Chirac wishing to appear sensitive to the concerns of the rest of the world, invited a number (12) of developing country Heads of State and Heads of Government to a one day meeting with him in June 2003, on the eve of the G7 Evian summit and offered to transmit their concerns to the other members of the G7. President Chirac's initiative was praised at the time by Tony Blair, the Prime Minister of the UK.

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<sup>14</sup> Op.Cit. page 107

## Conclusion

Diverse analysis lead to a widespread recognition of the need to reform the governance of the Bretton Woods, institutions currently dominated by the G7. The efficacy of the G7 itself is increasingly questioned. A number of proposals have been put forward to improve its effectiveness and legitimacy in global economic governance. Several of these coincide in their diagnosis of the problem and in the solutions suggested. They call for a more representative governance, to be attained through the enlargement of the group from 7/8 to some 15 to 20 members in order to encompass a broader range of countries. The aim would be to include countries that are major players or “systemically significant” in the international economy, and countries that exercise a degree of regional political leadership.

But moving toward the formation of a broader group will require the support of major industrial and developing countries. The Canadian government and in particular Prime Minister Martin is well placed to play a key role in this regard, persuading its G7 partners that it is desirable, if not necessary, to bring about the required transformation in global governance. As a group, the major developing countries, may be expected to be receptive to participate in a wider dialogue. Will the G7 countries have the vision to undertake the necessary reforms without a major crisis? Will the US be prepared to support such a move? If a significant group of industrial countries, say Britain, France, Germany, and Japan and a group of major developing countries such as Brazil, China, India, Korea and Mexico, decided to meet at the Head of State level, the US would find it difficult to stay away.