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G-20 Reforms of the International Monetary System: An Evaluation

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With great French fanfare the G-20 committed itself in Seoul, Korea a year ago “to build a more stable and resilient international monetary system (IMS), including by further strengthening global financial safety nets.” As subsequently elaborated by French President Sarkozy and other French government officials, the agenda for IMS reform included five elements: surveillance of the global economy and financial system, the international lender-of-last-resort mechanisms (global financial safety nets), the management of global capital flows, reserve assets and reserve currencies, and IMS governance.

On the road to the Cannes G-20 summit, the IMS reform agenda along with a number of other important issues was hijacked by the European crisis. Nevertheless, the G-20 countries and various international institutions conducted an intensive process of review and discussion of the IMS via conferences,

working groups, and reports. It is useful to take stock of what they did or did not accomplish.

My summary assessment is that the G-20’s journey involved some useful mutual education, but not much in terms of concrete accomplishments. There were no surprises relative to my preliminary expectations in May of this year.¹ On surveillance, the results are disappointing. The focus is on process, and there are no substantial new policy commitments with one exception. On the lender-of-last-resort issues, there only will be marginal steps forward. On the management of capital flows, the progress that has been achieved over the past several years has been loosely codified, which is a substantive achievement. On reserve assets and reserve currencies, there is essentially nothing new of note. On governance, the G-20 statements contain the ritually required endorsement of change, but not immediately.

In the remainder of this policy brief, I examine what the G-20 accomplished in each of these five areas.

SURVEILLANCE OF THE GLOBAL ECONOMY AND FINANCIAL SYSTEM

The international monetary system is the set of obligations, rules, conventions, procedures, and institutions that shape the international economic and financial policies of governments in their interactions with each other. Strong obligations and understandings are essential. In particular, each country should recognize its responsibility to promote global economic growth and financial stability through their policy choices. Equally important is the surveillance of whether countries are meeting their responsibilities and the potential for consequences if they are not.

It would have been desirable if as part of the G-20’s review of the surveillance of the global economy and financial system they would have embraced the establishment of a formal International Monetary Fund (IMF) obligation on countries

1. Edwin M. Truman. 2011. *The Outlook for International Monetary System Reform in 2011: A Preliminary Report Card*. Policy Brief PB 11-4 (May). Washington: Peterson Institute for International Economics.

with respect to global growth and financial stability where there is none today. It also would have been desirable to establish a more robust framework for surveillance of the global economy and financial system including potential sanctions for countries to create better incentives to play by the rules, old and new. Finally, it would have been desirable if the G-20, as part of its framework for strong, sustainable, and balanced growth (SSBG) and the associated mutual assessment process (MAP), could have produced, through a transparent process, a set of specific, quantified, and verifiable policy commitments to achieve the stated G-20 goals. On each of these three aspects, the G-20 delivered little in Cannes.

[T]hese small adjustments to the current system fall far short of a robust framework of surveillance of economic and financial policies with penalties for shortfalls in performance.

On the question of each individual country's obligation to promote the collective goal of global growth and financial stability, the G-20 endorsed (1) procedural advances in the form of the continuation of IMF reports on the spillovers of the policies of the large economies on other economies, (2) the continuation of IMF multilateral surveillance reports that pull together the key themes of other IMF multilateral surveillance activities with an emphasis on assessments of external imbalances, and (3) the establishment of a more formal framework through which the IMF staff and management integrate their bilateral and multilateral surveillance activities. The last piece could become a step toward the establishment of a formal IMF obligation to promote global growth and financial stability. However, these small adjustments to the current system fall far short of a robust framework of surveillance of economic and financial policies with penalties for shortfalls in performance. Moreover, with respect to IMF staff assessments of external imbalances and exchange rates, the G-20 only endorsed the IMF's publication of exchange-rate assessments when it is "appropriate" to do so, although IMF Managing Director Lagarde, prior to the meeting in Cannes, had endorsed the publication of assessments of the contribution of exchange rates to external imbalances.

The biggest disappointment coming out of Cannes in this area is with respect to the immediate demonstration of collective responsibility for SSBG through the MAP. Except with respect to possible near-term stimulus measures, no country made a new policy commitment. Seven countries (Australia, Brazil, Canada, China, Germany, Korea, and Indonesia) agreed to

allow their automatic stabilizers to work to cushion the effects of any downturn on their own economies and by extension on the world economy and to take discretionary measures to support domestic demand as appropriate. Aside from this mild promise, the Cannes Action Plan for Growth and Jobs offers little near-term support for the global economy. The broad thrust of the G-20 macroeconomic policy framework remains focused on fiscal consolidation and structural reforms.

Nine advanced G-20 countries reaffirmed their commitments at the G-20 meeting in Toronto in June 2010 to halve their fiscal deficits from 2010 levels by 2013, and to stabilize or reduce government debt-to-GDP ratios by 2016. It would have been preferable to reprogram those commitments in light of the weakened state of the global economy compared with 18 months ago. The advanced nine countries include Australia, Canada, Germany, and Korea. The latest IMF *Fiscal Monitor* projects that these four countries will meet their Toronto goals expressed in terms of general government fiscal balances. But one can be skeptical whether Germany, in particular, will be willing to give full play to its automatic stabilizers as German growth slows and possibly declines. The IMF *Fiscal Monitor* projects that France and the United States will fall short of their 2013 targets by about 0.5 and 1.0 percentage points of GDP respectively, but that was before the recent markdown of near-term growth in France and the announced fiscal response by the government. Italy, Spain, and the United Kingdom are the other three advanced G-20 countries. Each is projected by the IMF to meet its Toronto objective. It is not surprising, under the circumstances in the euro area, that Italy and Spain did not commit to letting the automatic stabilizers come into play in their economies. In the case of the United Kingdom, it would appear that the UK authorities have declined to promote global economic growth by reprogramming their fiscal austerity measures even though they are in a much better position to do so than several other countries.

In addition, very few policy statements by individual countries were quantified in the G-20 Action Plan for Growth and Jobs. The limited number of quantifications that are recorded repeat numbers already publicly associated with existing plans. Perhaps the G-20 will do better in the future. The leaders said that they would hold themselves accountable for delivering on their modest commitments, which is positive. The G-20 also will continue the MAP indicative guideline procedures designed to promote policy coordination, which is better than abandoning the exercise. One can hope that in the future the G-20 will also be more transparent about the application of those procedures and about their policy discussions.²

2. On November 11, 2011, the IMF posted on the IMF website a 203-page document of IMF staff reports for the G-20 Mutual Assessment Process which provides some indirect insights into the G-20 deliberations.

On the whole, the G-20 deserves low marks on its performance in Cannes on its self-imposed task of improving the IMS with respect to surveillance of the global economy and financial system.

LENDER OF LAST RESORT

Lender-of-last-resort issues in the IMS involve the conditional, but also the largely unconditional, provision of financial assistance to countries adversely affected by international financial crises. This assistance is principally provided through the IMF, but assistance may also flow bilaterally among central banks and via regional financing arrangements in Europe and in Asia. It would have been desirable if the G-20 had endorsed a broad, integrated approach to these issues that includes the facilities available for the IMF to lend, the resources that the IMF can use to support countries in financial crises, and a robust framework of cooperation between the IMF and regional authorities on mutually supportive financial and surveillance activities. The G-20 agreements in Cannes amount to a minor tweaking of the status quo.

On the lender-of-last-resort element of the IMS reform agenda what was delivered in Cannes is not a triumph of G-20 leadership.

The leaders endorsed a new IMF Precautionary and Liquidity Line (PLL), the details of which are not yet available. One consequence of this vacuum is that some observers think that the PLL could be used to provide IMF financial assistance to Italy or Spain. This is unlikely as the PLL is intended for countries “with strong policies and fundamentals facing exogenous, including systemic, shocks.” Few would argue that either Spain or Italy now fits this description.

The leaders also noted that central banks have a role to play in the provision of global liquidity. But the central banks were successful in preventing a commitment to institutionalizing their arrangements at the global level. It would appear that post-Cannes the field is left to the IMF and its new PLL.

On IMF resources, the focus of the G-20 leaders was on the short-term rather than the long-term needs of the IMS. While committing to make sure that the IMF has the resources to play its systemic role in the European crisis, the G-20 leaders were unable to achieve a consensus on how to do so. It is noteworthy that the possible role of a Special Drawing Rights (SDR) allocation came up in this context and is still on the table. It remains to be seen what the G-20 leaders might have been contemplating when they included a reference to

SDR in their communiqué. As was the case in 2009, a large allocation of SDR could increase confidence by providing a potential source of needed liquidity for many countries if the global economy were to plunge back into recession. In addition, countries inside as well as outside the euro area, in principle, could employ their additional holdings of SDR to supplement the resources of the European Financial Stability Facility. For the longer run, the IMS would benefit if the IMF had the authority temporarily to issue SDR in a global financial crisis, but this desirable reform will have to wait for another day or crisis.

The G-20 leaders did agree on “principles” for cooperation between the IMF and regional financial arrangements. They had been endorsed previously by the G-20 finance ministers and central bank governors. Procedurally, some might consider it a bit odd that these principles should be identified with the G-20 rather than with the IMF and the relevant regional financial arrangements. On the other hand, they are non-binding.

The principles are a step forward but they fall short of the robust procedures that some have advocated.³ Their stated goal is laudable: fostering rigorous and even-handed surveillance and promotion of common goals of regional and global financial and monetary stability. However, with respect to lending activities they do not go beyond the appropriate recognition that competition in laxity with respect to policy conditions on lending and facility shopping should be discouraged. On lending operations, as well as joint surveillance activities, the tone of the principles is defensive and arm’s length. The need for cooperation is recognized but not operationalized.

On the lender-of-last-resort element of the IMS reform agenda what was delivered in Cannes is not a triumph of G-20 leadership.

MANAGEMENT OF CAPITAL FLOWS

Over the past several years, national authorities and the IMF and Bank for International Settlements have devoted considerable attention to international capital flows and to analyzing the phenomenon of global liquidity. This renewed attention to capital movements has focused on inflows as well as outflows and on the policies of source countries as well as destination countries. While these efforts have not produced full agreement, they have contributed to greater consensus on a topic that has been fraught with controversy for decades. It is to the credit of those associated with the G-20 that they were able

3. See C. Randall Henning, 2011. *Coordinating Regional and Multilateral Financial Policies*. Working Paper 11-9. Washington: Peterson Institute for International Economics.

to sustain the degree of consensus that had emerged and to produce a set of “coherent conclusions for the management of capital flows drawing on country experiences” as the G-20 finance ministers and central bank governors had promised in April of this year.

Nevertheless, of the five elements of the IMS reform agenda, the G-20 achieved the most on this element because it was able to codify an emerging consensus.

Of course, the conclusions are explicitly non-binding on countries and do not limit national policy choices, except that they will affect policy choices. The conclusions correctly state that there is no obligation to capital account liberalization under the IMF’s legal framework, but they also articulate the longer-term goal for G-20 countries to be in a position to benefit from “free capital movements, while preventing and managing risks that could undermine financial stability and sustainable growth, and avoiding financial protectionism.”

Some critics who advocate the more extensive use of controls over capital movements, as well as those who criticize the policies of countries that condition such flows, will be critical of what the G-20 has codified in this area. In my view, however, the conclusions appropriately place policies on the management of capital flows in the relevant broad policy context, stress some of the pitfalls for individual countries and the system as a whole (via indirect effects) of national measures affecting capital flows, and do not exonerate countries that may be responsible for so-called push factors.

The conclusions (1) note classification challenges, but they cover measures that do and do not distinguish by residency or by currency, including prudential measures; (2) place possible measures in the context of other macroeconomic and financial stability policies; (3) stress the primacy of broad macroeconomic policies and the importance of not using capital flow management policies to avoid other needed policy adjustments; (4) caution that the use of measures should be temporary (countercyclical), transparent, and targeted; and (5) acknowledge that countries’ situations differ so that the design and application of measures affecting capital flows will differ as well. These five points provide guidance while not imposing rigid constraints. They also contribute to the establishment of a framework for more systematic IMF surveillance in this area.

The G-20 conclusions on the management of capital flows include a paragraph on the strengthening of financial sectors. The paragraph notes both the pluses in terms of a country’s

absorptive capacity and stability and the minuses in terms of increasing a country’s attractiveness as a (perhaps temporary) destination for capital flows. This paragraph is linked to a G-20 action plan to support the development and deepening of local currency bond markets. It is difficult to argue with the objectives of the action plan, but the rationale for the initiative is greatly overstated. The development of local currency bond markets can contribute to economic and financial stability and potentially affect the composition of international capital flows, but it is much more debatable whether or to what extent doing so will contribute to the stability of the IMS by reducing reliance on foreign saving, attenuating external imbalances, or mitigating the need for large precautionary reserve holdings, as is claimed as a benefit of the G-20 action plan.

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RESERVE ASSETS AND RESERVE CURRENCIES

Many observers point to the role of national currencies as the principal weakness of the IMS today. Those observers hoped that the G-20-sponsored IMS reform discussions would result, for example, in agreed limitations on the reserve role of the US dollar. They were off the mark in their analysis, in my view. Their underlying complaint is with the dollar’s role as an international currency in the international financial system, which is dominated by decisions of private sector actors and institutions. Moreover, the dollar is not the only international currency today; the list grows longer with each passing quarter, and the scale and currency composition of international financial assets is largely demand determined. Nevertheless, the focus of ruminations by the G-20 and within the IMF over the past year or so has been on promoting SDR as a replacement for the dollar as a reserve asset and promotion of the SDR to become a currency that is managed internationally. In the end, those ruminations, which one can hope were mutually educational, produced nothing of note.

The G-20 statement on the topic tellingly, but implicitly, recognizes the reality of the international financial system today in the relevant subheading in the Cannes Declaration: “reflecting the changing economic equilibrium and the emergence of new international currencies.” The international financial system and its IMS subcomponent have been evolving for decades toward a multi-currency system. That evolution has accelerated somewhat over the past 15 years since the birth of the euro, but there is little that collective public policy decisions can do to promote that evolution.

The initial paragraph in the Cannes Declaration on this element focuses on exchange rates and states a commitment to “move more rapidly toward more market-determined exchange

rate systems and enhance exchange rate flexibility to reflect underlying economic fundamentals, avoid persistent exchange rate misalignments and refrain from competitive devaluations.” Tellingly, these fine words speak more to the element of IMS reform that deals with surveillance of the global economy and financial system than to the role of reserve assets or currencies.

[T]he G-20 has nothing at which to point as substantive achievements on reserve assets and reserve currencies in the IMS.

With respect to reserve assets in general and the SDR in particular, the G-20 statement expresses agreement with the status quo in which the currency composition of the SDR basket reflects the role of currencies in the global trading and financial system. These are the existing criteria for including a national currency in the SDR basket. The IMF is asked to clarify them, and the G-20 promises to return to this issue in 2015 if not before. The subtext behind this agenda item is the inclusion of China’s yuan in the SDR basket, which is probable and desirable at some point in the future. Some thought that in return for a commitment that the yuan would be included in the SDR basket sooner rather than later China would either commit to increasing the flexibility of their exchange-rate regime in the direction of more rapid appreciation or put forward a more explicit timetable for liberalizing capital outflows and inflows, but the Chinese authorities declined to take the bait. From their perspective the gain in terms of political recognition apparently did not outweigh the potential losses in terms of the management of capital inflows and outflows and other economic and financial objectives.

For the future, the Cannes Declaration mentions continuing to work on the role of the SDR in the IMS, including as a “reference for appropriate reforms.” I regard these words as a sop to those who favor the creation of an international currency divorced from national decision makers. I hope that the G-20 and the IMF will now set these issues aside to focus on more important matters, such as limiting the accumulation of international reserves. The SDR could play a role in this area if at the same time the major countries were willing to recognize their obligations with respect to the performance of the IMS as a whole and submit to constraints on their decisions that affect prospects for global growth and financial stability via their reserve accumulation policies.

Meanwhile, coming out of Cannes, the G-20 has nothing at which to point as substantive achievements on reserve assets and reserve currencies in the IMS.

IMS GOVERNANCE

A well-functioning IMS within a robust international financial system must be supported by a governance structure that is both legitimate and effective. Indeed, French President Sarkozy included reform of global governance on his initial G-20 agenda and commissioned a report on this broad topic from UK Prime Minister Cameron. The Cannes Declaration contains several concluding paragraphs on governance that are primarily focused on the future and organization of the G-20 itself.

On governance of the IMS, which in principal is lodged in the IMF and loosely related groups such as the G-20, the leaders in Cannes broke no new ground. The G-20 statement repeated the commitment to implement expeditiously the IMF quota and governance reforms agreed in Seoul in 2010, which are intended to be in place by the fall of 2012. Implicit in this commitment is the associated agreement to move forward over the next year to consider again reforming the IMF quota formula so that it can be used in 2013 to reach agreement on a further increase in IMF quotas by January 2014. The relevant language in the Cannes Declaration on IMS governance reforms is a commitment to “an appropriate transition toward an IMS which better reflects the increased weight of emerging market economies.” In addition, the G-20 leaders agreed that their ministers and governors should be more involved in the International Monetary and Financial Committee (IMFC), which in principle could enhance the IMFC’s role in surveillance over the global economy and financial system, including via increased transparency.

On balance, with respect to governance of the IMS, the G-20 leaders broke no new ground.

CONCLUSION

The IMS reform agenda was overwhelmed in Cannes by the European crisis. Flaws in the IMS had little to do with the global financial crisis or the European coda directly. This is one reason why the IMS reform agenda did not generate much traction in advance of the G-20 leaders’ meeting. The European crisis might have some lessons for IMS reform in terms of what is realistic and desirable, but it will take some time to absorb those lessons. Based upon the results of the IMS reform discussions in 2011, it will also be some time before there is meaningful IMS reform. Some IMS reforms are desirable, but few are essential. Meanwhile, the system will continue to evolve.

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