Reforming Global Financial Governance: Opportunities and Challenges for the BRICS

Mark S. Copelovitch
Assistant Professor
Department of Political Science &
Robert M. La Follette School of Public Affairs
University of Wisconsin – Madison
306 North Hall, 1050 Bascom Mall
Madison, WI 53706
copelovitch@wisc.edu

INTRODUCTION

Financial globalization – the explosive growth in the size, depth, and complexity of international markets – is the defining characteristic of the contemporary world economy. Over the last three decades, private international capital flows to developing countries have grown exponentially, from nearly zero in 1970, to $491 billion in 2005.\(^1\) Daily foreign exchange trading has increased from $850 billion in 1986, to $3.2 trillion in 2007.\(^2\) In the first quarter of 2007, commercial banks reported $25 trillion in total foreign claims, up from $17 trillion in 2005.\(^3\) At the same time, international investors held over $20 trillion in sovereign and private bonds, with net issuance increasing at 18% per year.\(^4\) Unfortunately, as starkly illustrated by the ongoing global economic crisis, this resurgence of financial globalization has been accompanied by a corresponding increase in the frequency and severity of financial crises.\(^5\) In addition to becoming more frequent and severe, these crises are also increasingly global in scale: as cross-border international financial integration has deepened and accelerated, it has become the norm, rather than the exception, for financial distress in one country to transform rapidly into broader regional and global financial instability. In the current crisis, for example, the collapse of cross-border interbank lending in 2007-2008, as a result of the subprime mortgage crisis the United States, led directly and rapidly to the failure of Northern Rock (the eighth-largest bank the United Kingdom) and the dramatic collapse of Iceland’s economy. The sharp decline in exports

\(^1\) World Bank 2006.
\(^2\) BIS 2007a.
\(^3\) BIS 2007b.
\(^5\) Bordo, et. al. define financial crises as “episodes of financial-market volatility marked by significant problems of illiquidity and insolvency among financial-market participants and/or by official intervention to contain such consequences” (2001, 55). Financial crises encompass both banking crises, in which financial distress erodes the capital reserves of the banking system and results in the failure of major banks in a country; and currency crises, in which governments face speculative attacks on their exchange rates. In most major financial crises, both elements (banking distress, currency crashes) are evident.
around the world, along with the subsequent spread of financial instability to Eastern Europe – and, most recently, to the “Club Med” members of the eurozone (Greece, Portugal, and Spain) – underscores further the potentially negative consequences of international financial integration.

In light of these developments, it has become increasingly clear that the existing institutions and rules of global financial governance – what has come to be known as the “international financial architecture” – are obsolete and in need of reform. Broadly, this architecture consists of three key pillars: 1) the informal “steering committee” of major economic powers – embodied for the last three decades by the G-7 group of advanced industrialized countries, but now supplanted by the Group of Twenty (G-20); 2) the formal, multilateral international financial institutions (IFIs): the International Monetary Fund (IMF) and the World Bank; and 3) the less visible but critically important global committees of financial regulators and central bankers, most of which are headquartered at the Bank for International Settlements (BIS) in Basel, Switzerland. Over the last two years, we have seen substantial reforms to each of these pillars, and these changes will have important implications for the BRICs countries in both the short- and long-term.

My goal in this paper is to discuss the progress and prospects for reform of each of these pillars of global financial governance, in order to shed light on the opportunities and challenges these changes create for the BRIC countries. First, I will discuss the key reforms that have been implemented or proposed, to date, including the elevation of the G-20 to a central role in global financial governance, as well as the substantial increase in the IMF’s resources and the somewhat less substantial reform of its governance structures and lending policies. Second, I will address the implications of these reforms for the BRICs, with an eye to both the question of how reform may affect domestic policies in these countries and the potential of the BRICs, as a
bloc, to shape the future evolution of the international financial architecture. Finally, I will conclude with some brief thoughts on the broader implications of the rise of the BRICs for the future of globalization and the structure of the international financial system.

The BRICs: a relevant concept?

Before addressing these issues, however, let me say a few words on the concept of the BRICs. It is important to remember that it was Goldman Sachs, rather than the countries themselves, that first coined this term in 2001. Thus, rather than identifying a group of states engaged in formal economic or political cooperation, the BRIC label was meant simply to be a classification of large “emerging market” countries who shared little more than impressive economic growth prospects and the potential to become the largest economies in the world by 2050. In the ensuing decade, these countries have embraced the label themselves and many have spoken about this group as a rising political force in the international system.

Nonetheless, we need to keep in mind three key points when considering the BRICs’ emerging role in global financial governance. First, the BRIC label masks enormous economic and political differences between the four countries (Brazil, Russia, India, and China). On the economic side, there are substantial discrepancies in production structure and patterns of international economic integration. For example, while Brazil specializes heavily in agriculture and Russia in commodity exports, the economies of India and China are heavily weighted toward services and manufacturing exports, respectively. Likewise, the overall level of trade and financial integration of these countries varies substantially, as do levels of poverty and inequality (Table 1).
Finally, on the political side, the BRIC countries exhibit broad differences in levels of democracy, corruption, and the rule of law.

Given all of these differences, is the BRIC label/concept at all useful in seeking to understand the dynamics of global financial governance? Martin Wolf, the well-known and widely respected columnist on international economic issues at the *Financial Times*, recently addressed this important question:

> “Does it [the term BRICs] have analytical relevance? My answer is: no and yes. No, because the four countries have next to nothing in common, apart from the fact that none is a high-income country. Yes, because the notion captures a reality of our era, which is sustained ‘catch-up’ growth across large parts of the developing world.”

My assessment is largely in line with Wolf’s view. To this point, the only real themes unifying the four BRIC countries have been: size, rapid economic growth, and the belief that the United States (or the G-7 as a group) should not be so dominant in global economic governance. These commonalities are important, and it is unquestionable true that the balance of economic power in the world has shifted dramatically in the last decade as a result of the BRICs’ rapid growth and development. For this reason alone, it is nearly impossible to imagine that international financial stability can be restored and maintained in the coming years if the BRICs are not given a stronger role in the IMF and other key institutions of global financial governance. Nevertheless, we should be careful not to overestimate the degree to which the BRICs’ emergence has (and will) alter the balance of power within these institutions or the substantive content of the policies

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they produce. To date, the actual impact of the BRICs on the politics and politics of the international financial institutions (IFIs) has been extremely limited, and this appears unlikely to change much in the foreseeable future. In contrast, as I discuss further below, reform of the IFIs – as well as the further evolution of international capital flows – is quite likely to substantially shape and constrain the national economic policies of the BRICs in the coming years.

**Reforming Global Financial Governance: Progress and Prospects**

**From G-7 to G-20**

The first key reform issue in global financial governance is the emergence of the G-20 as the informal “steering committee” of the world economy. For three decades, the G-7 (Group of Seven) unofficially held this role. It first met in France in 1975, to ratify the *de facto* move to floating exchange rates following the collapse of the Bretton Woods system, and it subsequently became the key forum in which finance ministers and chief executives of the leading economic powers met to discuss key global issues. The group – encompassing Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States – cooperated effectively on monetary matters in the 1980s, most notably via the Plaza and Louvre accords, which resulted in coordinated foreign exchange intervention to stem and reverse the dollar’s sharp appreciation in 1985, and to halt its depreciation in 1987. In recent years, however, it became clear that the G-7’s influence and relevance had diminished, due in large part to its members’ declining relative prominence in the global economy compared to the BRICs and other fast-growing emerging market countries (Table 2). Although Russia was admitted to an enlarged G-8 in 1997, the continued exclusion of the remaining BRICs (particularly China), as well as several other major economies (e.g.,
Australia, Saudi Arabia, Mexico, and Korea) rendered the G-8 increasingly illegitimate and ineffective.

Table 2: Country shares of total G-20 output (percent)\(^7\)

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<tr>
<td><strong>Industrial countries</strong></td>
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<tr>
<td>United States</td>
<td>46</td>
<td>31</td>
<td>33</td>
<td>24</td>
<td>15</td>
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<td>EU-4</td>
<td>26</td>
<td>30</td>
<td>25</td>
<td>16</td>
<td>7</td>
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<tr>
<td>Japan</td>
<td>15</td>
<td>21</td>
<td>20</td>
<td>11</td>
<td>4</td>
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<tr>
<td>Others in G-20(^1)</td>
<td>2</td>
<td>4</td>
<td>4</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>89</td>
<td>86</td>
<td>82</td>
<td>54</td>
<td>28</td>
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<td><strong>Emerging markets</strong></td>
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<tr>
<td>China</td>
<td>1½</td>
<td>1</td>
<td>4</td>
<td>15</td>
<td>20</td>
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<tr>
<td>India</td>
<td>1½</td>
<td>1</td>
<td>2</td>
<td>5</td>
<td>15</td>
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<tr>
<td>Korea(^3)</td>
<td>½</td>
<td>1</td>
<td>2½</td>
<td>6</td>
<td>10</td>
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<tr>
<td>Brazil</td>
<td>2½</td>
<td>3</td>
<td>3</td>
<td>4</td>
<td>5</td>
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<tr>
<td>Russia</td>
<td>–</td>
<td>3</td>
<td>3</td>
<td>4</td>
<td>3</td>
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<tr>
<td>Others in G-20(^2,3)</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>13</td>
<td>20</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>11</td>
<td>14</td>
<td>18</td>
<td>46</td>
<td>72</td>
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1. Australia and Canada.
2. Argentina, Indonesia, Mexico, Saudi Arabia, South Africa, and Turkey.
3. Projected using growth rates of other G-20 emerging market economies.
SOURCE: Bergsten 2004

As the has G-7 declined in importance, attention shifted to the G-20 as a potential replacement. The G-20 was established during the last round of major reforms to global financial governance, in the wake of the Asian financial crisis of 1997-99. Initially, the G-20 was intended to be a supplement to the G-7: the former would address specific issues concerning the global financial system, while the latter would remain the central forum for broader issues of security and international cooperation. As a result, the G-20’s meetings...

were limited to the level of finance ministers and central bank governors. Effectively, the G-20 expanded the G-7 “guest list” to include 12 major economies: Argentina, Australia, Brazil, China, India, Indonesia, Mexico, Russia, Saudi Arabia, South Africa, South Korea, and Turkey. In addition, the European Union (EU) gained a formal seat at the table, with both the member-state holding the European Council Presidency and the chief of the European Central Bank (ECB) represented. Similarly, the heads of the IMF and World Bank (as well as the chairs of the Fund’s International Monetary and Financial Committee and the Bank’s Development Committee) also participated, in an effort to bring greater coordination to the activities of the major IFIs.

For most of the last decade, the G-20 confined its work to important but low-profile technical issues, such as increasing coordination in the fight against terrorist financing and tax evasion, and fostering the adoption of a variety global financial regulatory standards. However, the current crisis has marked a clear turning point for the group: at the 2009 London Summit, it became clear that the G-20 – rather than the G-7/8 – was now the world’s preeminent forum for international economic cooperation. This transition was formally acknowledged in October 2009, when the G-7 decided to end its regular summits by 2011, thereafter meeting only on an informal, ad hoc basis as deemed necessary. As Alastair Darling, British Chancellor of the Exchequer, noted, “the main focus will be the G20 for some time to come.”

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8 [http://g20.org/about_what_is_g20.aspx](http://g20.org/about_what_is_g20.aspx).
Looking ahead: does the G-20 change anything?

Although the elevation of the G-20 has given the BRICs countries their long-desired seat at the table of global economic governance alongside the G-7 states, it remains to be seen whether and how this matters at both the international and domestic levels. Internationally, the key question is whether the G-20 is really more than a “talking shop.” To date, not much has been accomplished in concrete terms: aside from formally anointing itself as the G-7’s replacement and agreeing to substantially augment the IMF’s resources (discussed further below), the G-20 has not taken any major, substantive steps toward resolving the global economic crisis or further reforming the international financial architecture. On one level, this is not particularly surprising: aside from the aforementioned 1985-87 cooperation on exchange rates, the G-7/8 rarely agreed or implemented major policy reforms at its summits, so the lack of G-20 initiatives was likely to be expected. On another level, however, the lack of progress by the G-20 bodes ill for its future relevance on key global financial matters. It remains to be seen, for example, whether the G-20 will work in normal (i.e., non-crisis) times, or whether it will – like the G-7/8 previously – remain primarily a figurehead organization, with key, substantive policy reforms being decided and implemented within the IMF, through the various BIS-oriented regulatory bodies, and/or by outside cooperation by smaller groups of major countries (e.g., bilateral agreements between the US and China). Moreover, the lack of agreement on how to respond to the current crisis highlights the central and most worrying problem with the G-20: it is simply too big and diverse to be a forum in which major policy decisions are negotiated and agreed. This problem is only likely to get worse, as additional countries
push for seats at the enlarged table of global economic governance.™ Going forward, therefore, we are quite likely to see sub-groups of the G-20 – whether in the form of the old G-7, or (more likely) a “G-2” or “G-4” consisting of some combination of the US, China, Japan, and the European Union – agreeing to new initiatives and then bringing them to the G-20 forum for de facto “ratification” and implementation.♪

These concerns aside, the elevation of the G-20 does have a possible upside. If its members can overcome these barriers to cooperation and reach agreement on a meaningful set of new initiatives to enhance global financial stability, these new policies will have substantially greater credibility around the world – particularly among developing countries. Simply put, it will no longer be the case that the US and its G-7 partners are dictating the rules of the global economy to the rest of the world. Rather, by virtue of the full participation of the BRICs and the other leading emerging markets (Indonesia, Korea, Mexico, Turkey), the G-20’s policies should enjoy greater legitimacy than those of its G-7 predecessor in the developing world. Of greater concern than who should participate in the G-20, then, is what the group should be doing. Aside from bolstering the IMF’s resources, a wide variety of issues have been placed on the G-20’s agenda, including: coordinating domestic macroeconomic stimulus packages, spearheading global regulatory initiatives, deciding on further IMF reform, and addressing broader issues such as climate change and the stalled Doha Round at the World Trade Organization (WTO). Which of these goals, if any, will become the key issue around which G-20 cooperation will coalesce in the near future remains very unclear.

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10 We have seen this already. Spain and the Netherlands, which were initially excluded from the G-20, have been invited as de facto members to the summits in the last two years.
11 There is substantial precedent for this. For example, the 1980s Basel Accord on capital adequacy for internationally-active commercial banks originated as a bilateral agreement between the US and the UK before it was officially agreed by the Basel Committee on Banking Supervision as a multilateral standard. See Singer 2007.
Given this lack of consensus on what the G-20’s main agenda item(s) should be in the coming months and years, the fact that the BRICs are now at the table does not mean much yet, either for changes in global financial governance or for the BRICs’ own national economic policies. Indeed, until meaningful policy changes and governance reforms emerge from the G-20 process, it is unlikely that the BRICs will get much out of their newly-elevated status beyond a boost to their international prestige. Rather, the reforms occurring within the IMF and the BIS-related regulatory institutions, which I discuss in greater detail in the sections below, are more likely to have long-term implications for the BRICs.

The IMF: Resurgence and reform

While the rise of the G-20 has grabbed headlines, the revitalization of the fortunes of the International Monetary Fund (IMF) has been the most important development in global financial governance in the wake of the global crisis. After a decade in which many lamented its obsolescence and imminent demise, the IMF (and how to reform it) is once again a central topic of discussion among policymakers and academics.\(^{12}\) As the financial turmoil deepened and spread across the globe in 2008-2009, the Fund once again assumed its central role as the *de facto* international lender of last resort, or crisis lender, to developing countries. Over the last 18 months, the Fund has provided more than $50 billion in loans to 20 countries hit hardest by the crisis, including Belarus, Iceland, Hungary, Latvia, Pakistan, Romania, and Ukraine. In addition,

\(^{12}\) See, for example, Edwin M. Truman, “IMF Reform: An Unfinished Agenda” (http://www.petersoninstitute.org/publications/opeds/oped.cfm?ResearchID=1106). There are also a variety of reform issues related to the World Bank. While critically important, these issues are more closely related to development rather than questions of global financial stability and crisis management. Consequently, I limit my focus here to the IMF. For excellent overviews of the issues related to World Bank reform, see Birdsall 2006 and Woods 2006.
Mexico, Columbia, and Poland have taken advantage of the IMF’s new precautionary lending window, the Flexible Credit Line (FCL), in order to stave off crises. These loans represent an additional $50+ billion in IMF commitments, although they have yet to be disbursed.

This resurgence in IMF lending represents a sharp reversal from the start of the decade, when few emerging market countries borrowed from the Fund and many observers questioned the continued relevance of – and need for – the IMF in an apparently stable global economy awash in private international capital flows. Yet while global financial crisis has rescued the IMF from near-irrelevance, the Fund still faces several serious challenges in the coming years. These fall, broadly, into two categories: resources and governance. In this section, I will discuss each briefly, in turn, before considering the implications of reforms to address these challenges for the BRICs.

**Resources: ensuring the IMF has enough money**

Thus far, the main efforts at IMF reform in response to the current global financial crisis have addressed the question of resources. Simply put, the IMF does not have enough money to do its primary job of providing lender of last resort financing to countries experiencing financial crises.\(^{13}\) When the current crisis boiled over in September 2007, the IMF’s lending capacity was roughly $200 million from regular quota resources and an additional $50 billion from established borrowing arrangements with the advanced economies.\(^{14}\) Given the magnitude of private capital

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\(^{13}\) Strictly speaking, the IMF is not a true lender of last resort (LOLR), as it cannot (in contrast to national central banks) issue its own currency, and its loans do not meet Walter Bagehot’s (1873) classic criteria. Nonetheless, the IMF is the closest substitute to a LOLR in the current world economy, and its lending programs serve much the same purpose for sovereign borrowers as crisis lending by a national central bank does for distressed private financial institutions.

\(^{14}\) The IMF operates similarly to a credit union: each member-state provides a portion of the Fund’s lendable “quota” resources and is eligible to borrow in proportion to these contributions. Country quotas
flows in today’s global financial system, this is woefully inadequate: global holdings of international debt securities now total $20.7 trillion, while new debt issues in 2007 alone reached almost $400 billion. Likewise, the Fund’s quota resources relative to world trade have fallen by more than a factor of ten since its creation in 1944. In short, the IMF’s available resources are now dwarfed by the sheer magnitude of international trade and international capital flows. Thus, the first major challenge confronting the Fund is the urgent need for more money.

The G-20 countries’ commitment to substantial increase the Fund’s available resources is, therefore, the most significant reform of global financial governance in the last year. In February 2009, the Japanese government committed an additional $100 billion to bolster the Fund’s $250 billion in lendable resources. Soon after, Dominique Strauss-Kahn, the IMF’s Managing Director, announced plans to seek a doubling of the Fund’s coffers to $500 billion, a plan subsequently endorsed by the new US Treasury Secretary, Timothy Geithner. In March, the European Union (EU) responded with its own commitment to provide $100 billion in resources to the Fund. At the G-20 summit in London in April 2009, these pledges were reinforced by a formal commitment on the part of G-20 governments to triple the Fund’s resources to $750 billion, through a mix of $500 billion in loans and a one-time issuance of $250 billion in Special Drawing Rights (SDRs), the IMF’s notional currency. Proposals are now on the table to formally index IMF quotas to the expansion of global trade and financial flows, so that the Fund’s resources increase in line with the future growth of the world economy.


IMF, Global Financial Stability Report, April 2008, Table 2, Statistical Appendix, 146.


Nevertheless, some economists estimate that the Fund would require an additional $750 billion to $1.75 trillion in order to be fully equipped to handle “a systemic emerging market crisis” in the coming years.\(^{18}\) Who will provide these resources – and how this will affect power and influence within the IMF – leads to the second major challenge facing the Fund: the need to reform its governance structures and decision-making rules.

**Governance: reforming IMF voting and enhancing legitimacy**

Although it deserves its fair share of blame for not addressing the underlying issues that caused the global economic crisis (e.g., the problem of global imbalances and the surge in capital inflows to Eastern Europe), The IMF has received generally high marks for its policy responses once the crisis began in full. Indeed, the Fund has been praised by many knowledgeable observers for its effective role in stabilizing the faltering Eastern European economies, for adopting a strong, visible stance in favor of fiscal stimulus to counteract the global recession, and for its efforts to modify its lending programs to address longstanding complaints by borrowers countries about the stringency and excessiveness of conditionality – the policy reforms the IMF mandates in return for its loans.\(^{19}\) In spite of these policy successes, however, the IMF continues to suffer from basic governance anomalies that hamper its legitimacy and threaten to undermine its future effectiveness if not addressed in the coming years. How to address these issues and reform the rules and institutions of IMF governance is, like enhancing the Fund’s resources, a pressing topic in the debate about how to reform the international financial architecture.

The core governance problem facing the IMF is the widely held belief that the Fund and its policies are biased toward the interests of the United States and the major European

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shareholder countries. This belief, as it turns out, is well-grounded in reality. Since its creation in the 1944, the IMF’s Managing Director (MD) – the Fund’s CEO – has always, by convention, been a European national, just as the United States has always appointed the President of the World Bank. Second, the United States and other large shareholders – in particular, the “G-5” countries holding their own seats on the Fund’s Executive Board (US, UK, Germany, France, Japan) – exercise disproportionate influence over IMF policies and lending decisions. In order to see why these countries enjoy such power within the Fund, it is useful to briefly consider how IMF decision-making works in practice.

The IMF’s member-states are its shareholders and formal political principals. Acting through the Executive Board (EB), a 24-member body composed of Executive Directors (EDs) representing shareholder governments, member-states have the final say over all IMF policy decisions. However, because member-states’ voting power is directly proportional to their quota contributions to the Fund’s general resources, the advanced industrialized countries’ preferences carry the most weight in Fund decision-making. As the Fund’s five largest shareholders, the “G-5” countries (United States, United Kingdom, Germany, Japan, France) are entitled to appoint their own EDs, who hold a combined 38.4% of the votes, while EDs from constituencies encompassing the G-7 (G-5 plus Canada and Italy) cast a combined 46.1% of EB votes, and those representing the G-10 (G-7 plus Belgium, the Netherlands, Sweden, and Switzerland) collectively cast nearly than two-thirds (62.3%).

Table 3 shows the current distribution of voting power within the Executive Board. Since many of the Fund’s non-lending decisions require EB super-majorities of 70-85%, this voting

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20 The Group of 10 comprises the 11 countries that participate in the major global financial regulatory institutions at the Bank for International Settlements and have made supplementary credit commitments to the IMF through the General Arrangements to Borrow (GAB) and the New Arrangements to Borrow (NAB): http://www.imf.org/external/np/exr/facts/gabnab.htm.
structure gives the advanced industrialized countries collective (or the United States, with 16.77% of the votes, unilateral) veto power over a wide range of Fund policies, including quota increases, the sale of IMF gold reserves, and amendments of the Articles of Agreement.
This veto power does not extend to IMF lending decisions, however: formally, approval of an IMF loan requires the support of only a simple majority of EB votes, rather than a super-majority. Moreover, the Board’s norm is to avoid formal votes on lending decisions whenever possible. Rather, lending decisions are made on a “consensus basis with respect given to the relative voting power of the states.” Ultimately, these formal rules and informal decision-making norms give the IMF’s largest shareholders \textit{de facto} control over Fund lending decisions.

\begin{table}[h]
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\caption{IMF Executive Board voting shares, December 2009}
\begin{tabular}{ll}
\hline
Country & Percentage share \\
\hline
United States & 16.77 \\
Japan & 6.02 \\
Germany & 5.88 \\
France & 4.86 \\
United Kingdom & 4.86 \\
\textit{G-5 total} & \textit{38.39} \\
Italy & 4.10 \\
Canada & 3.64 \\
\textit{G-7 total} & \textit{46.13} \\
Belgium & 5.14 \\
Netherlands & 4.78 \\
Sweden & 3.44 \\
Switzerland & 2.79 \\
\textit{G-10 total} & \textit{62.28} \\
Spain & 4.45 \\
China & 3.66 \\
Indonesia & 3.52 \\
South Korea & 3.44 \\
Egypt & 3.20 \\
Saudi Arabia & 3.16 \\
Sierra Leone & 3.01 \\
Russia & 2.69 \\
Iran & 2.42 \\
Brazil & 2.42 \\
India & 2.35 \\
Argentina & 1.96 \\
Korea & 1.35 \\
Other total & 37.63 \\
\hline
\end{tabular}
\end{table}

\textbf{SOURCE:} International Monetary Fund

In fact, as Table 3 illustrates, the G-5 countries must garner the support of only three other EDs from rich countries in order to assemble a Board majority and control IMF lending decisions. Empirically, there is substantial evidence that these governing rules bias IMF lending policies in favor of countries with close economic or geopolitical ties to the US and its G-5 counterparts. This fact is widely recognized by countries throughout the developing world, many of whom have become reluctant to seek IMF assistance as a result. In particular, the East Asian countries have complained loudly that conditionality imposed by the IMF during the Asian financial crisis was too onerous, and they point to their lack of voice within the IMF’s decision-making process as evidence that the Fund is really a “Euro-Atlantic” Monetary Fund, which treats countries backed by Brussels or Washington more leniently than other borrowers. The IMF’s recent “kid glove” handling of Latvia has only perpetuated this view. As a result, governments throughout the developing world view the IMF as both ineffective and illegitimate, and they are increasingly reluctant to seek its financing. In fact, in the decade since the Asian financial crisis in the late 1990s, many emerging market countries, including Korea, Taiwan, and India, have sought to “self-insure” themselves against future crises by building up large war chests of foreign exchange reserves.

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22 See Copelovitch 2010 for both a review of the extensive empirical literature on the political economy of IMF lending, as well as a detailed argument about the extent of G-5 influence over time and across cases.

23 Subramanian 2009.

24 The Fund allowed Latvia to avoid devaluing its currency in the face of a 24% current account deficit, presumably on the grounds that the Latvian government is actively seeking to join the eurozone in the near future. Such a policy would, quite likely, not be tolerated by the IMF when lending to a Latin American or Asian country facing similar financial and macroeconomic difficulties.

Thus, reform of IMF governance in order to enhance the Fund’s legitimacy and relevance in the future is a critical issue. For this reason, many observers have proposed changes to the Fund’s internal decision-making rules in order to increase the voice of the BRICs and other under-represented countries. Although the details of these various reform proposals vary, all start from the standpoint that IMF lending is excessively influenced by political pressure from the United States and other large shareholders, with countries closely allied (either geopolitically or economically) to these states receiving more preferential treatment from the Fund. Therefore, the proponents of reform argue, changing the quota allocations and voting weights in the EB to give other states – specifically, the BRICs and other large emerging market countries such as Mexico, Turkey, and Korea – a greater say in IMF decisions and would lead to more efficient and equitable policy outcomes. In short, advocates of governance reform see the redistribution of “chairs and shares” within the EB as a way to both democratize and de-politicize IMF decision-making, with a corresponding increase in the Fund’s legitimacy and effectiveness.

Recently, these governance reform proposals have led to concrete changes: the IMF’s shareholders approved a modest redistribution of voting rights and quotas within the Fund in April 2008. Under the terms of these reforms, approximately five percent of IMF quotas (and therefore, EB votes) will be reallocated in order to increase developing countries’ voice within Fund decision-making. Given the rules of IMF decision-making, however, this limited reform will not substantially alter IMF lending outcomes. In fact, the current reforms do nothing to change the essential balance of power with the IMF: G-5 governments will still retain enough

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26 For an overview of the various non-governmental organizations (NGOs) that have criticized the IMF and other IFIs, see Elliott, et. al. 2002.
27 Truman 2006.
29 For a detailed analysis of these reforms, see “Experts Critique Proposal for International Monetary Fund Quota Reform,” Brookings Institution, April 9, 2008 (http://www.brookings.edu/opinions/2008/0409_imf_linn.aspx).
voting power to exercise *de facto* control of the Executive Board. Consequently, we are unlikely to see substantial changes in the politics of IMF lending in the near future.\(^{30}\)

**IMF reform: the way forward**

Given the limited impact of these current reforms, a number of key observers have advanced further plans for altering IMF governance. Edwin Truman has called for amending the IMF’s Articles of Agreement to reduce the 85% supermajority on major Fund decisions to 80%, which would eliminate the ability of the US (or the Europeans as a bloc) to unilaterally veto major policy changes, such as quota reviews. Truman and others have also, accurately, identified the over-representation of Europe on the EB as the key governance problem within the IMF.\(^ {31}\) Presently, European countries hold or control ten of the 24 seats on the EB (Table 3), with EU member-states directly or indirectly controlling 37.5% of the votes. Moreover, the voting shares of several of these European countries (e.g., the Netherlands, Belgium) are no longer representative of their global economic power and increasingly unjustifiable given the size and under-representation of the BRICs. Consequently, several reform proponents have called for a consolidation of Europe’s representation within the IMF, with the EU countries holding a single seat and the vacated seats and shares to be redistributed to the BRICs and other under-represented countries in Asia and Africa.\(^ {32}\) Finally, Ngaire Woods and Eswar Prasad have proposed that – either in place of, or in addition to, reallocating voting shares and seats –

\(^{30}\) See Bryant 2008.

\(^{31}\) It is interesting to note, in contrast, that the US is slightly *under*-represented on the EB (~17% of the votes), relative to its global share of GDP (~27%).

\(^{32}\) Truman 2006. See also Simon Johnson, “The IMF Should Move to Europe,” [http://www.iie.com/realtime/?p=952](http://www.iie.com/realtime/?p=952) and Alan Ahearne and Barry Eichengreen, “Resetting Europe’s Place at the Global Financial Table” [http://www.voxeu.org/index.php?q=node/646](http://www.voxeu.org/index.php?q=node/646). Interestingly, giving up seats might enhance Europe’s power within the IMF, since technically the EU would become the largest shareholder and – by virtue of the Articles of Agreement – have the right to host the Fund’s headquarters.
the Fund modify its decision-making procedures for lending to require “double majorities” (i.e., a majority of EB votes, plus a majority of Board seats). Under this system, the G-5 countries would still retain their disproportionate influence as a result of their quota contributions, but they would require the support of at least 8 other Board members in order to approve a Fund lending arrangement. As Woods argues, “This reform would immediately create an incentive for the powerful members of the board to forge alliances with a larger number of borrowing countries – large and small. Equally, it would give borrowing members an incentive to participate more actively, more constructively, and with greater input into the strategic decisions made [in the IMF].”

All of these reforms would give the BRICs an enhanced voice in IMF policymaking. Such influence, however, would come largely at the expense of the European countries, which have dug in their heels against any further reform beyond the symbolic voting reallocations implemented last year. Whether this European opposition persists remains an open question. The next key test of this is likely to be the selection of the next Managing Director. Rumors abound that the current director, Dominique Strauss-Kahn, will resign early (before his term ends in November 2012) to return to France and become the Socialist candidate for president against Nicolas Sarkozy. If and when that occurs, there will be substantial pressure for the Europeans to relinquish their monopoly on the MD position as a gesture toward enhancing the Fund’s legitimacy. Whether a BRIC national might become a viable candidate in such an open succession race is unclear. However, a number of Indian economists (e.g., Eswar Prasad; Arvind Subramanian; or Amar Bhattacharya, the head of the G-24 group of developing countries) have

33 Woods 2006, 210. Under Prasad’s proposal, existing IMF quotas would be shrunk by 20% across the board, and these newly-available quotas would be auctioned, with an upper limit on any country’s share. This would give more voice, effectively, to those countries most willing to contribute more resources to the IMF. See Economist, “The IMF: Mission: Possible,” April 8, 2009.
substantial past experience within the IMF and would be strong candidates to become First Managing Director, the Fund’s second-in-command. Traditionally, this position has been held by a US national, although the US has signaled its willingness to relax this claim in the future. In any case, while a non-European MD would have less impact on IMF policymaking than more substantial voting reform, it would nevertheless send a clear signal to the developing world that the IMF is committed to addressing its legitimacy gap in the coming years.

*Will governance reform matter, and how?*

Thus, while IMF governance reform remains a work-in-progress, the key issues are widely understood and we are likely to see further efforts in the future to address the Fund’s problems of legitimacy. That said, let me end the discussion IMF governance by raising a cautionary point that has, unfortunately, been entirely missing from the reform debate. To be sure, the redistribution of “chairs and shares” within the Fund will enhance the influence of the BRICs and reduce the ability of the US and its European counterparts to utilize IMF lending for their own domestic financial or geopolitical purposes. If more extensive reforms – including double-majority voting and the reduction in the number of European seats on the EB – are implemented, the IMF’s legitimacy and relevance will be enhanced, and its role as the central institution of global financial governance will be reinforced. For this reason, further governance reform is a laudable goal worthy of greater discussion and debate. Nevertheless, governance reform will not remove politics from the IMF. Indeed, even if the Fund were to eventually approve a more extensive reallocation of Executive Board seats and voting shares, there is little reason to believe that such reforms will actually de-politicize IMF lending and lead to policy outcomes driven solely by economic efficiency. In fact, reducing G-5 governments’ influence
over IMF policymaking would not eliminate member-states’ individual financial interests from the Fund’s decision-making calculus; rather, it would simply replace G-5 interests and influence with the domestic political and economic concerns of other EB member-states. For example, just as Mexico and Korea received favorable treatment from the IMF in the 1990s, due in part to G-5 governments’ strong financial stakes in these countries, they might continue to receive bailouts in the future if the voting weight of the BRICs or other major emerging market countries increased at the expense of the G-5. One can think of this outcome as a further manifestation of the moral hazard problem: emerging market borrowers, wielding their newly-acquired influence within the IMF, might secure larger loans with less stringent conditionality than they currently could obtain under the existing voting structures.

In sum, while many proposals to reform IMF governance have substantial merit and are undoubtedly well-intentioned, they fundamentally misunderstand the inherently political nature of IMF decision-making. As long as the Fund’s member-states have the final say over IMF policies, their domestic political and economic interests will invariably shape the Fund’s lending behavior. Although these domestic interests may change in content as non-G-5 countries gain more seats at the table, they will never be entirely eliminated so long as the basic decision-making rules of the IMF remain in place. Simply put, no amount of voting reform will completely purge politics from IMF lending, since the Fund is ultimately responsible to its member-state shareholders and will remain so regardless of changes in its internal decision-making procedures. Ultimately, the question is about whose political interests IMF lending serves, rather than whether the Fund can be transformed into a purely technocratic, apolitical institution.
The final pillar: enhancing global financial regulation

While the G-20 and IMF have dominated discussions about reform of the IFIs in the past year, some of the most important changes have taken place behind the scenes. Since the 1980s, a web of international financial regulatory bodies has coalesced around the Bank for International Settlements (BIS) in Basel, Switzerland. The BIS, established in 1930 (originally to administer German war reparations), has long been a forum for central bank cooperation; its membership now includes 55 countries. The BIS also hosts the secretariats for a number of important committees that bring together regulators from the advanced economies; these include the Basel Committee on Banking Supervision (bank regulation), the Committee on Payment and Settlement Systems (payments and clearing), and the Committee on the Global Financial System (market stresses and systemic stability). In addition, the BIS also hosts the secretariat for the Financial Stability Forum (FSF), an umbrella organization formed, like the G-20, following the Asian financial crisis to bring together regulatory and financial authorities in major economies with representatives of the IFIs and the aforementioned BIS-hosted committees. The FSF has been the main institution linking this growing list of regulatory bodies, and it has spearheaded technical work on a number of key topics (e.g., offshore financial centers, deposit insurance systems, and highly leveraged institutions) of importance in recent crises.

Together, these regulatory bodies have made substantial progress in developing numerous international financial standards and harmonizing financial regulation across the world’s major markets. As with the G-7 and the IMF, however, these less visible but important institutions have – until recently – been comprised only of representatives from the advanced industrialized economies. This changed at the April 2009 G-20 summit in London, where the FSF was elevated in status to the Financial Stability Board (FSB) and membership was extended
to the entire G-20, along with Spain and the EU Commission.\textsuperscript{34} In the ensuing months, talks have accelerated among the FSB’s participants on a number of key topics, including compensation in the financial sector, enhancing regulators’ ability to “unwind” large, cross-border financial institutions in the event of failure, and strengthening adherence to international financial standards. Talks are also underway among G-20 regulators about the imposition of a global levy on internationally-active banks.\textsuperscript{35} These are important, if less visible, developments in global financial governance, since the central bankers and regulators involved in the FSB and the other Basel-based institutions meet regularly and have the direct ability to implement policies at the national level. Thus, the BRICs’ participation in these institutions gives them the opportunity to have an important say in the future evolution of global financial regulation.

Having said that, we should not overestimate these institutions’ role and effectiveness, for two reasons. First, given the market power of the US, UK/EU, and Japan in the global financial system, it is still the case that these countries’ national policies – rather than internationally-negotiated standards – have the greatest impact on the activities of internationally-active financial institutions. Therefore, the outcome of the current debate about financial regulatory reform in the US and UK (e.g., whether or not the “Volcker rule” becomes law in the US, and whether the anticipated Tory government in the UK abolishes the Financial Services Authority and returns regulatory power to the Bank of England) will largely determine the contours of the future agenda within these global regulatory institutions. Simply put, very little of substance will happen in terms of global financial regulation until and unless domestic regulatory reform is completed in the largest financial markets. Second, the lack of enforcement power in the FSB and the BIS-related committees makes implementation of new financial regulation difficult at the

\textsuperscript{34} http://www.financialstabilityboard.org/press/pr_090402b.pdf, See also http://www.financialstabilityboard.org/.
global level, even if G-20 officials can reach agreement on the substance of reform. For global regulatory rules and standards to be effective, national regulators and central bankers must enforce them, and this raises difficult problems of credibility, particularly in some of the BRICs (Russia, China) where the independence of central bankers and regulatory officials is less clear and institutionalized than in the advanced industrial democracies. Thus, it remains to be seen whether the enlargement of global regulatory institutions actually leads to more extensive and effective supervision and regulation of international financial markets.

**GLOBAL FINANCIAL GOVERNANCE: OPPORTUNITIES AND CHALLENGES FOR THE BRICs**

What do these developments in the reform of the international financial architecture mean for the BRICs countries? To what extent will the BRICs play a central role in shaping patterns of global financial governance in the future? Clearly, there are no easy and obvious answers to these questions. Therefore, let me conclude with three broad (and somewhat tentative) conjectures about both the challenges and opportunities that the reform process presents for the BRICs. First, as I have already said, we should be careful not to overestimate the degree to which the BRICs’ ascendance has changed the fundamental dynamics of global financial governance. Despite the reforms discussed above, very little has changed about the substance of international financial cooperation or the politics of the IFIs. Certainly, the elevation of the G-20 gives the BRICs full status as members in the elite “club” of countries managing the world economy. However, the basic contours of formal power in the IFIs remain largely unchanged, and this is unlikely to change substantially in the foreseeable future. For the time being, therefore, the main impact of the BRICs’ rise on the politics and policies of global financial governance will be indirect: the US and its G-7 counterparts will no longer be able to set policies
among themselves without considering the reaction of the BRICs, as well as how those policies will affect economics and politics in the major emerging market countries. In contrast, the BRICs’ direct influence – on IMF lending decisions and the substance of global financial regulation – is likely to be quite limited. For the foreseeable future, the US and its G-7 counterparts still, more or less, call the shots in terms of regulating the global financial system and managing international financial crises.

The possible exception, of course, is China, which now wields ever-greater influence over international economic and financial issues, even if its formal power within the IFIs remains limited. This fact leads to the question of whether China will, over time, seek to disengage itself from the BRICs and form a “G-2” (with the US) or a “G-4” (with the US, EU, and Japan) of truly “great powers” in the global economy. Such a development is certainly likely in the medium- to long-term, and it would undoubtedly weaken the BRICs’ ability to cooperate and jointly influence policy within the IMF, the G-20, or the Basel regulatory institutions. Even if this were to occur, however, the remaining “BRI” countries would continue to rise in size and importance in the global economy, and the G-2 or G-4 would still need to engage them – along with the remaining G-20 countries – in order to effectively address key questions about international financial regulation, crisis management, and the like.

Thus, the real question is not whether the BRIC grouping survives intact, but whether these countries will find themselves on the same side of particular policy issues within the IFIs. My second conjecture, in answer to this question, is that we are likely to see more and greater disagreements among the BRICs over global economic issues as time progresses and these countries’ many differences become more pronounced. Consequently, I believe that we are unlikely to see strong agreement and effective collective action by these countries within the
IMF, the G-20, or the Basel regulatory institutions. Likewise, I am skeptical that the BRICs will achieve much of substance through their informal cooperation as a bloc. Above all, the future economic prospects for these countries are quite variable and uncertain, and it is not clear that their rapid growth trajectory will continue. Indeed, each of the BRICs faces unique problems that could undermine its economic success in the coming years and alter their preferences on issues such as exchange rates, regulation of international capital flows, and global financial regulation. Russia, for example, remains excessively dependent on high commodity prices for economic growth (more than 70% of its exports are in mining/fuels), and its future political trajectory remains unclear. Brazil faces serious problems of domestic poverty and inequality, as well as a sharply lower savings/investment rate than the other BRICs. India’s future economic success depends critically on the outcome of its ongoing security challenges in the neighborhood. And finally, the economic and political ramifications of an eventual 25-40% appreciation of the renminbi – both for China and for the broader global economy – remain uncertain.

Thus, while the BRICs will likely continue to rise further in the “league table” of the global economy in the next fifty years, it is by no means guaranteed that they will become dominant, nor is it certain that all four of these countries will remain on equally ascendant trajectories. In fact, several decades from now we may view on one or more of the BRICs the way we now evaluate Japan, which was widely expected in the late 1980s to surpass the US as the leading global economic power, only to find itself mired in two decades of crisis and stagnation during the 1990s and 2000s. My own view is that such a reversal of fortunes is most likely with Russia, given its commodity dependence and political uncertainties. However, it is by no means unreasonable to expect even China to face serious difficulties and crises in the
coming decades that could drastically alter its economic fortunes and its political influence at the global level.

My skepticism about the future success and impact of BRIC cooperation in the global economy is reinforced by the fact that – beyond their individual domestic problems – the BRICs have an increasing number of political disagreements between themselves that may lead their “sum” as a bloc to be less than their individual “parts” in the global economy. Trade disputes have been common among the four countries, for example. Brazil has fought with both Russia and China over market access, and its interest in full agricultural liberalization in the Doha trade round has angered India, which wants to maintain protection for its domestic rice producers.36 On the geopolitical front, significant tensions and differences also exist. Brazil is the only non-nuclear power among the four, and its geographic separation from its BRIC counterparts gives it a very different outlook on global security issues. Meanwhile, China and India remain locked in conflict over border disputes and in competition for access to Russia’s energy and natural resources. These differences matter not only for foreign policy and international security, but also for global financial governance, since the BRICs’ ability to influence policy within the G-20, IMF, and elsewhere in the future will depend critically on their ability to coordinate their views and cooperate as a bloc. Absent such agreement, the BRICs (again, with the possible exception of China) are likely to continue to be overshadowed by the old G-7 countries, with key decisions about the regulation and governance of international finance remaining in the hands of the US, Japan, and the EU countries.

My final conjecture is that the most important and significant effect of the BRICs’ rise to prominence in global financial governance will be on these countries’ own domestic policies,

rather than on the policies of the IFIs. In short, the BRICs’ new status as great powers in the world economy brings with it new responsibilities and expectations about how these countries will behave with respect to trade, monetary, and financial policies. As members of the elite club of global economy governance, the BRICs will, in the coming years, find themselves subject to increased scrutiny by international investors and their G-20 counterparts, both of whom will expect their governments to adhere more closely to the trade, monetary, fiscal, and financial regulatory policies of the advanced industrialized countries, rather than to those adopted (or not adopted, as the case may be) by smaller and less prominent emerging market countries. The specific impact of these raised expectations on the BRICs’ national economic policies will depend on the issue area in question, as well as the gap between the BRICs’ policies and those of the G-7 countries.

In any case, however, it is quite likely that the BRIC governments and central banks will find themselves with less autonomy to pursue certain key economic policies (e.g., China’s active use of the exchange rate as a tool of trade protection, Russia’s threats to cut off oil and gas supplies to Eastern Europe) that have been key to their rapid growth and economic development in the last decade. Such policies are, ultimately, incompatible with a leadership or hegemonic role in the global financial system, and the BRICs’ ability to exert meaningful influence within the institutions of global financial governance will remain limited so long as they continue to pursue them. Even Brazil’s recent use of inward capital controls, which (in contrast to China’s exchange rate policy or Russia’s energy policy) is not viewed as a “beggar they neighbor” policy, has raised eyebrows, given that a commitment to capital account openness is all but a
given among the advanced industrialized countries in the contemporary global economy.\textsuperscript{37} In sum, the BRICs’ rising prominence in global finance will have significant ramifications for their domestic economic policy choices in the years to come. Whether or not further reform IMF and other IFIs occurs in the coming years, this is likely to be the most lasting and significant effect of the BRICs’ accession into the G-20 and the broader international financial architecture.

References


