The United States and International Economic Governance

Joseph P. Joyce

Among the unexpected outcomes of the global financial crisis of 2008-9 has been the end of the domination of international economic governance by the U.S.US and other upper-income countries through the forum of the G7, and its replacement by the G20. The depth and breadth of the economic contraction required a broader response than the advanced economies alone could provide, and its origin in financial markets in the United States undermined its support for neoliberal policies. Now that the global crisis has passed, the G20 must demonstrate whether it can serve as an effective forum for monitoring and managing the global economy.

RISE OF THE G7

When the Bretton Woods system of fixed exchange rates and controlled capital flows ended in 1973, the United States brought together France, Germany, and the United Kingdom, and later Japan and Italy, to discuss its replacement. The national executives of these countries held their first summit meeting in Rambouillet, France in 1975 to address the impasse that had developed over how the IMF's Articles of Agreement should be amended. The compromise they reached allowed nations to choose the exchange rate regime they wanted (the goal of the United States) while committing the IMF's members to pursuing policies aimed at economic stability (France's concern), with the IMF providing surveillance of its members' policy performance. The agreement became the basis of the Second Amendment to the IMF's Articles of Agreement that was adopted in 1978.

This group of nations, which became known as the G7 after Canada joined it in 1976, would continue to manage international economic issues during the next thirty years. The finance ministers of the G7 met several times a year to discuss common interests while deputies stayed in contact between meetings. They also prepared for the annual summits of their national executives, who issued communiqués which detailed their policy agendas and listed instructions for the multilateral agencies. While the issues they addressed soon expanded outside of the economics sphere to include foreign policy matters, economics would remain a primary focus, in part because of the leading role of the finance ministers. In 1997, the G7 expanded to include Russia as a member of the new G8. But the finance ministers of the G7 continued to meet as a group, and the G7 national leaders continued to deal collectively with economic issues, such as debt relief, for the developing economies.

The G7 governments were able to act cohesively in part because they shared common views and interests. The West European nations opposed central planning and the expansion of the Soviet Union and its Eastern European satellites. Canada, Germany, Italy, and the United Kingdom were members of the North Atlantic Treaty Organization, while France established a working relationship with the organization. In Asia, Japan depended on the United States to protect it from aggression.

While there were disagreements among the G7 countries over issues such as exchange rate arrangements, their common interests more than outweighed any differences.

The influence of the G7 extended to multilateral organisations such as the IMF. Before 2008, the United States held 17.38% of the quota shares that are used to calculate voting power at the IMF, thus effectively giving it a veto over proposals that required approval of 85% of the total voting power. The G7 nations collectively held 46.02% of the total. Representatives of the United States, Japan, Germany, France, and the United Kingdom held positions for their respective countries on the Fund's Executive Board, while the Canadian and Italian Directors represented multi-country constituencies. Moreover, the agreement of the United States and their European allies that the Managing Director of the IMF would always be a European while the United States would name the head of the World Bank continued to hold.

The ability of the upper-income countries to dominate the IMF was reinforced by the change in the clientele of the IMF's lending programs after the 1970s. The advanced economies no longer borrowed from the IMF, and the IMF's traditional lending programs became concentrated on those middle-income nations that experienced financial crises. The IMF also lent, on concessional terms, to the poorest nations that received relatively little private finance, augmenting the World Bank's remit. The advanced economies, exempt from the conditions attached to the IMF's loans, endorsed the adoption by the IMF and the World Bank of a new form of conditionality, 'structural conditionality'. These were measures that sought to increase a country's reliance on the market allocation of resources by cutting back on governmental enterprises and regulations, and opening the economy to international trade and financial flows.

The G7 also effectively controlled international financial regulation through their membership with other advanced economies in the Bank for International Settlements and its affiliated agencies, such as the Basel Committee for Banking Supervision. In 1988, following an initiative by the United Kingdom and the United States, the Basel Committee established a standard of capital requirements for the banks of its member countries, which were eventually adopted in many other countries. Similarly, the Basel Concordats of 1975 and 1983 established rules for the oversight by national regulators of banks that operated across borders. The regulators had allowed their banks to expand geographically, but subsequent banking crises revealed a lack of transnational regulatory authority.

The G7 countries had similar influence at the General Agreement on Trade and Tariffs (GATT) and its successor, the World Trade Organisation (WTO). Negotiations over trade liberalisation were dominated by the 'Quad' – Canada, the European Union, Japan, and the United States. Their representatives met in 'rounds' to negotiate cuts in tariffs while keeping some sectors, such as agriculture, off the agenda. Those nations that did not have significantly sized markets, which included most developing economies, were able to opt out of the process. This allowed the Quad and other advanced economies to make deals without the participation of the developing economies.

The G7 and other countries expanded the scope of trade talks with the Uruguay Round, which was negotiated from 1986 through 1993. The final agreement established the World Trade Organisation as the GATT's replacement, and included services and intellectual property as areas of jurisdiction. In addition, an administrative process to resolve disputes between members was created. The new regime embodied a broad view of the scope of the WTO's purview to include any domestic policies that might impede trade.

By the early 1990s the United States had emerged as the winner of the Cold War, and appeared to have an unchallenged hegemonic dominance. It and other upper-income countries were able to promulgate an expansive vision of economic globalisation. The members of the G7 formed a collective principal that utilised the multilateral organisations as their agents to implement this vision. The G7's restricted membership and relatively homogeneous views allowed them to operate effectively despite occasional disagreements. They were also aided by the disappearance of communism as a viable alternative to capitalism, and the adoption by many developing economies of market-based policies to accelerate growth.

CRISES AND CHALLENGES

The domination of the global economy by the United States and other G7 countries, and their use of the multilateral agencies, became increasingly controversial in the latter half of the 1990s. A series of financial crises occurred: Mexico in 1994-95, East Asia in 1997-98, Russia in 1998, and Argentina and Turkey in 2001. The IMF provided financial assistance to the crisis countries, but the conditions attached to the IMF's loans were criticised as overly strict. Moreover, the IMF itself was blamed by some for contributing to the occurrence of the crises by urging these countries to prematurely decontrol capital flows.

The G7 responded to the resultant volatility in the international financial markets by establishing a new organisation, the Financial Stability Forum (FSF). The membership of the FSF included the G7 plus Australia, Hong Kong, the Netherlands, Singapore, and Switzerland. The FSF brought together finance ministries, central bankers, and other regulators to coordinate their oversight of financial flows and institutions, but the organisation had no independent powers to administer regulatory guidelines.

The Basel Committee for Banking Supervision published in 2004 a revised and extended set of minimum requirements for bank capital, known as Basel II. The new standards allowed banks to choose the methodology they used to calculate their exposure to credit risk, and the options included the use of internal evaluation models, as well as a standardised approach based on the ratings generated by the rating agencies. The choice of methodology favoured larger banks in the advanced economies that had the resources to calculate risk exposure. Subsequent events revealed that the guidelines contributed to the volatility of the financial system by underestimating the risk of financial assets such as mortgage-backed securities.

Many of the middle-income countries, which were now called the 'emerging market' nations due to their rapid economic expansion, sought to eliminate any dependence on the IMF by 'self-insuring' themselves from future financial shocks. Their governments adopted stable macroeconomic policies that led to lower inflation and improved fiscal and debt positions. They also recorded current account surpluses which allowed their central banks to accumulate large holdings of foreign exchange reserves. These surpluses were offset by current account deficits in the United States, the United Kingdom, and several other advanced economies. The growing magnitude of these 'global imbalances' was accompanied by fears of a sudden reversal of capital flows to the United States by foreign investors. The IMF sought to broker a reduction of the imbalances through multilateral consultations it organised in 2006-07 with China, the Eurozone, Japan, Saudi Arabia, and the United States, but the talks did not result in changes in any of the participants' policies.

The G7 also faced a challenge to their authority as a result of the WTO negotiations. After the implementation of the Uruguay Round agreements, discussions of a follow-up round of trade negotiations began. The new round was to be launched at a WTO ministerial conference in 1999, but ministers from the developing countries opposed efforts to expand the talks to include areas such as the environment and labour standards. The meeting in Seattle collapsed without attaining a consensus over how to proceed, and was marred by street riots denouncing the WTO and policies aimed at promoting globalisation at the cost of national sovereignty.

The next WTO ministerial meeting took place in 2001 in Doha, Qatar, and this time the ministers agreed on the inauguration of a new round of trade talks. This was known as the 'Doha Development Round' in acknowledgement of the need to extend the benefits of trade to developing nations. However, there have been continuing disagreements between advanced economies and the emerging market and developing nations, as well as within each group. Agriculture has been a particular source of discord. The United States and the European Union have disagreed over reductions in their agricultural subsidies, while developing nations with large rural populations such as India have resisted the removal of barriers to agricultural imports.

The authority of the United States, therefore, became challenged on several fronts during the decades of the 1990s and 2000s. The response of the emerging markets countries to the endemic

financial crises demonstrated that they would take their own measures to protect themselves from further financial volatility. The rapid growth of China and India demonstrated that it was possible to achieve rapid growth and alleviate poverty by implementing national strategies to control the pace and degree of integration with international markets. The governance of the multilateral organisations came under attack as unresponsive to the changes in the relative economic status of their members, and the increasingly confident emerging markets felt no reluctance in criticising the form of globalisation endorsed by these organisations.

IMPLOSION

The worldwide economic collapse that occurred during 2008-9 destroyed any illusions that the advanced economies were immune from crises. This crisis originated in the United States but also included the financial sectors of other advanced economies in Europe. The loss in confidence in financial institutions and markets necessitated government intervention in the form of low interest rates, capital injections, deposit guarantees, and other measures designed to maintain confidence. The emerging market and other developing economies were not immune to the ensuing contraction in trade and capital flows, and suffered slowdowns in their growth rates. The volume of world trade in goods and services fell by 10.7% in 2009, and world output contracted by 0.7%.

But the latter figure encompassed a range of different experiences (see Chart 1). While the output of the advanced economies fell by 3.7%, economic growth continued in the emerging and developing economies, albeit at a slower pace of 2.8%. This disparity in economic performance was particularly evident in the world's largest economies. Output in the United States contracted by 3.7% in 2009, while the Eurozone's output suffered a fall of 4.3%. Economic activity in China, on the other hand, barely slackened and registered an impressive growth of 9.2%, while India's economy expanded by 6.8%.

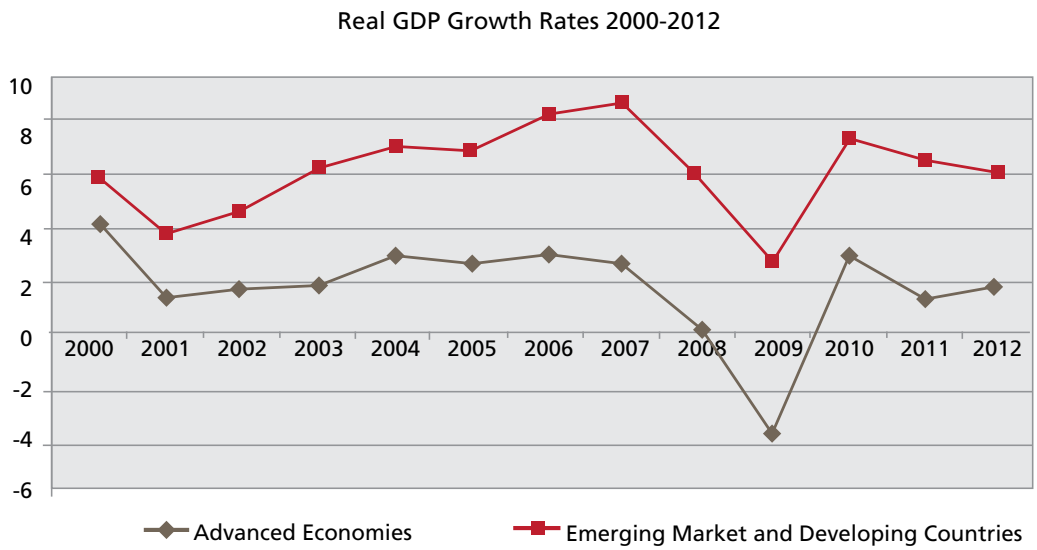

Chart 1: Percentage growth rates of Real Gross Domestic Product, 2000-2012. Data for 2011 and 2012 are estimates. Data from IMF's World Economic Outlook, September 2011.

The global impact of the crisis required a broader response than the G7 could provide. French President Nicolas Sarkozy and British Prime Minister Gordon Brown led the way in calling for a meeting of the G20 in the fall of 2008. In addition to the G7 countries, this group includes Argentina, Australia, Brazil, China, India, Indonesia, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, and the European Union. The group had been established in 1999 to expand the discussion of economic and financial issues to include emerging market nations that attracted capital inflows, but it had never conducted a summit of their national executives. However, the G20's existing structure and record of cooperation among its members allowed it to serve as an alternative to the G7.

The first summit meeting of the G20 leaders took place in Washington, DC, in November 2008 during the closing days of the Bush administration, and did not yield any initiatives beyond agreeing to address the common crisis and undertake reforms of their financial sectors. H owever, United States President-elect Barak Obama attended the next summit in London in April 2009, and this time the national leaders agreed on a number of important measures, including the implementation of concerted fiscal and monetary expansionary policies. They also approved tripling the financial resources of the IMF, and transformed the Financial Stability Forum to the Financial Stability Board with an expanded membership of all G20 countries as well as Spain and the European Commission. In addition, the G20 leaders agreed on a package of IMF reforms, including quota realignments, the selection of the senior leadership of the international financial institutions through an open merit-based process, and 'candid, even-handed and independent' IMF surveillance of their economies.

When the G20 leaders met again in September 2009 in Pittsburgh, United States, they declared victory in their efforts to end the global economic contraction. The leaders reaffirmed their support of the IMF and the new Financial Stability Board, and designated their own group as the 'premier forum for our international economic cooperation'. They called for international financial regulatory reform, including changes in the Basel capital standards. Finally, the national leaders promised to bring the Doha Round to a successful conclusion and to reach agreement at the climate summit scheduled to take place in Copenhagen. The meeting confirmed that the crisis had served as a catalysis for a major rearrangement of the relative position of the advanced and emerging market economies, with the latter group achieving parity with the former in their oversight of the world economy.

CONCLUSIONS

The unity of purpose expressed at the first three G20 summits has not endured. By the time of the G20 summit in Toronto in June 2010, divisions had emerged over whether deficit spending was still an appropriate policy. At the fifth G20 conference in Seoul in November 2010 there were disagreements over the use of numerical indicators in assessments of national economic policies, while the lastmost recent summit in Cannes was dominated by discussion of the European debt crisis. No progress has been made at the Doha trade talks, and the climate conference in Copenhagen in December 2009 ended without any substantive agreements.

Some progress has occurred in other arenas. The IMF agreed on a redistribution of quota shares that will make China the third largest quota-holder, and increased the allocations to other emerging market nations. However, its members missed an opportunity to geographically open up the selection of a Managing Director when they elected France's Christine Lagarde to the position to replace Dominque Strauss-Kahn after his unexpected resignation. The Basel Committee on Banking Supervision has, with an expanded membership, proposed a new set of regulatory guidelines with higher capital requirements for banks, to be known as Basel III.

The prospects for the G20 actually replacing the G7 as a mechanism to deal with common concerns, however, are limited by the disparities in national economic performance. Economic growth for the advanced economies has been estimated by the IMF at 1.6% in 2011 and 1.9% for the following year, and the European estimates for the European market may prove to be optimistic. The comparable figures for the emerging market and developing economies are 6.4% and 6.1%, respectively.

The European countries have become embroiled in the debt crisis that includes Greece, Ireland, and Portugal, and threats to envelop Spain and Italy. The United States itself faces deep domestic divisions over the need to reduce its government debt while dealing with unusually high unemployment rates. Moreover, virtually all the advanced economies must address fiscal challenges due to the impact of aging populations on the costs of pension support and health care.

The G20 is useful for providing a forum for consultations, but the size of its membership and the disparity in their economic circumstances makes consensus much harder to attain. This need not bring about economic anarchy; governments have generally been careful not to enact trade restrictions or currency depreciations which would invite retaliation. But the lack of a common outlook and goals ('preference heterogeneity') among the members makes collective decision difficult to achieve.

The United States no longer has the will or means to dominate international economic governance, but there is no clear replacement. The prospects, therefore, are for an extended period of lower level accords, with bilateral and regional trade agreements and currency arrangements replacing international pacts. An era of multipolarity will effectively continue the status quo that preceded the global crisis of 2008-9. There is no evidence that we are better able to foresee and avoid another shock, and given the concerns over national debt levels, the policy options for dealing with a new disaster will be more limited should another shock arise.■