



Global economic governance at a crossroads

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Global economic governance has undergone a radical transformation with the emergence of a new and unsettled, yet consistent and diffused, international financial order. This Policy Note analyses the reform, tracing its causes, examining its manifestations and assessing its pervasive implications, particularly as regards the significant transfer of power from advanced countries to emerging market economies as well as its consequences for international financial institutions. This encompassing approach enables the definition of the key features of the new order, leading to conclude that the international financial architecture has become more resilient: new tools and institutions for international coordination have become available and the old ones can be used more flexibly. The Note finally argues that a more united Europe in the international arena would not only be beneficial to Europe but it would also improve the quality of global economic governance.

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Introduction

The frequent headlines on harsh international disputes on trade and their implications on consumer and business confidence worldwide have made the issue of global economic governance so prominent that it has reached out of the realm of experts and has entered the day-to-day life of the public at large. The widely-held perception is that, at the current juncture, global governance faces a crossroads: successfully defending and adapting the prevailing multilateralism, or moving to a new system of bilateral relations, dominated by the economic rivalry as well as by the political confrontation between the US and China.

Against this backdrop, this Policy Note, which draws on the analysis of Monticelli (2019), takes stock of the deep transformation in global economic governance that has taken place since the great financial crisis of 2008-9. It outlines the salient features of the new global economic order, which is still in the making, and assesses its pervasive implications. While shunning away from predictions on the future of international financial architecture, the analysis concludes that the world economy is more resilient. New tools and institutions for international coordination have become available and the old ones can be used more flexibly. Global economy and finance can be better managed – if there is the political will to do so.

1. A radical reform – in spite of institutional continuity

Global economic governance has undergone a radical transformation. To the many officials and commentators directly involved in international relations, this conclusion is self-evident – just a generalization of the change in the balance of power between major countries they daily experience in their formal and informal meetings at international groups and institutions. Yet, it stands in stark contrast with the assessment of several distinguished scholars of international relations: *The System Worked* and the *Status Quo Crisis* are the self-explanatory titles of the books by, respectively, Drezner (2014) and Helleiner (2014).

Admittedly, continuity has been a remarkable feature of the functioning of global governance after the 2008 crisis, in particular as regards the persistence of the US dollar as the pivot currency of the international monetary system and the endurance of the

international standards regime in financial regulation. Yet, much more crucial transformations have occurred, causing a regime break. The international supremacy of the US in economic affairs has been repeatedly and successfully defied. The voting power and the informal clout within international financial institutions have dramatically shifted in favour of the key emerging market countries. The proliferation of regional financing arrangements, despite their inadequacies, has questioned the G7-led monopoly of the Internationally Monetary Fund (IMF) in the provision of emergency financing during crises.

Even more conspicuously, the G20 has replaced the G7 as the key decision-making forum on global economic and financial matters. Its effectiveness in this function is arguably inferior to the achievements of the G7 in its heydays, as shown by its inability to marshal consensus on many of the crucial issues facing the global economy. These inadequacies however should not mask the fact that the G20 has become the key forum of international economic cooperation, where, since the 2008 Washington summit, all the key international decisions have been formally or informally negotiated.

This overhaul in the balance of power that has materially changed global economic governance has not yet been accepted in principle and absorbed in practice by the US and the other advanced countries, which still resent it and try to resist it. On their part, emerging economies consider the transfer of power in their favour as insufficient, and continue to question the legitimacy and representativeness of international financial institutions. The new global regime remains unsettled and incomplete, fuelling frustrations and mutual recriminations. These sentiments underpin the resurgence of nationalism and trade disputes, which threaten the liberal order and the global economic and financial integration it allowed.

2. Causes underpinning the reform of global economic governance

Although the 2008 crisis acted as a catalyst for the reform, the change in regime had other fundamental causes. The G7 order progressively failed to deliver. It was unable to exert peer pressure on its own members and prevent the inappropriate macroeconomic policies and the inadequate supervision of the financial sector underpinning the 2008 crisis. Even more fundamentally, the G7 had

experienced a drastic reduction in its relative economic weight: in the previous twenty years, the G7 countries had lost a third of their share in world GDP, which returned below 50 per cent, as it was at the end of the 1800s.¹

The explosion of the crisis provided the key emerging market economies with the opportunity to demand the more important role in global governance, to which they had long been aspiring. Due to a series of serendipitous events,² the G20 was the forum where this demand was most forcefully expressed. It became the group around which the reform in global governance was centred with a marked shift in power towards emerging economies.

Despite its short life, the effectiveness of the G20 has varied significantly across times and issues. This mix of successes and failures is testimony to the unsettled order emerging from the reform of global governance.

3. The International Monetary Fund and the Multilateral Development Banks

Another key element of the reform in global governance regards the International Financial Institutions (IFIs) and the profound changes in the two-way interaction with their shareholders. The decision of the G20 to give IFIs major responsibilities in the policy response to the 2008 crisis revived their prominence in global governance, after many years when their function and legitimacy had been bitterly criticized. In April 2009 the G20 London summit deliberated on a massive increase of the IFIs' resources on the condition of a significant shift in voting power in favour of emerging economies.

The shift in power went beyond the increase in their voting rights. It also involved a significant boost in the clout on day-to-day decision making, acquired through greater recognition in the informal contacts that shape the decisions of the IMF. Although insufficiently appreciated because of the confidentiality of the IMF's deliberations, this influence is one of the qualifying elements of the reform in global governance. Moreover, under the influence of emerging economies, new elements – such as a more benevolent attitude towards some

form of capital controls – have been incorporated in the IMF's framework, confirming its adaptive nature.

With the G20 decision to use multilateral development banks as a key instrument of the response to the crisis, they received a huge boost to their capital once again on the condition of a reform to enhance emerging market economies' influence. Conscious of the effectiveness of multilateral banks' business model, emerging economies were eager to defy the prevailing order by founding two new institutions (the New Development Bank and the Asian Infrastructure Investment Bank) to challenge the advanced economies' monopoly and to prepare useful building blocks for the new international financial architecture.

China swayed the setting of this agenda, directing it toward its commercial and geopolitical priorities, much to the irritation of the other emerging economies, which went along nonetheless: the foundation of new institutions was too important a step towards a more multipolar governance. Negotiations with China were harsh and led to various concessions on its part both on various aspects of the two new banks and on the resources to establish a new financial arrangement (Contingency Reserve Arrangement, or CRA) providing support, in the event of a crisis, to the so-called BRICS (Brazil, Russia, India, China and South Africa).

4. The persistence of the international standards regime

Emerging market countries were less successful in acquiring influence in the other new institution established after the crisis: the Financial Stability Board, which was tasked by the G20 with the ambitious objective of spearheading “sweeping reforms” on a wide range of issues in financial regulation.

International financial regulation was an important concern for emerging economies, given that the pre-crisis international standards regime was firmly entrenched in the power relations of the G7-based system: standards largely drew on US rules and practices, while emerging market economies were neither members of most of the standard setting

¹ The gains of this epochal shift in economic power mostly accrued to a relatively small number of countries, with three – China, India and Brazil – benefitting for about two thirds of the fall in the G7 share of the world GDP.

² Chronicled and analysed in detail in Monticelli (2019).

bodies nor of the predecessor of Financial Stability Board.

Despite their participation in all these bodies, emerging market economies have gained little clout on the shaping of financial regulation. They have maintained a rule-taking attitude which stands in sharp contrast with their influence in every other aspect of global economic governance. In addition to the resistance of advanced countries, other factors account for this puzzling fact. First, emerging countries were reluctant to invest political capital in international regulatory disputes. Second, they did not have sufficient technical expertise and human capital to be effective in negotiations. Finally, and so far unnoticed as an explanation for advanced countries' command over financial regulation, the dollar has continued to be the pivot of the international monetary system. The dollar's role is a key factor in the shaping of financial regulation through two main channels: the support it provides to the supremacy of US banks in global finance, and the priority assigned by all large international banks, irrespective of their nationality, to have direct access to the Federal Reserve's dollar facilities, requiring them to be chartered in the US and hence subject to US regulation.

5. Improved tools for global economic governance

"Never let a good crisis go to waste"³ was the precept often repeated in international official circles to provide impetus to the reform efforts initiated by the Washington summit in November 2008: crises offer opportunities for radical changes that are not otherwise possible. Ten years on, the deep and pervasive reform in global economic governance suggests that the crisis was not wasted, at least in this domain.

The reform has attained a radical change, which was long due, in the balance of power between advanced and emerging economies, associated with a remarkable enhancement of its legitimacy and considerable progress towards multipolarity. The reform has led to the establishment of new international financial institutions and arrangements, as well as to profound and pervasive innovations in the modus operandi of pre-existing formal and informal institutions. These transformations have

provided the international community with a new array of institutional and operational tools, which have greatly increased the flexibility and effectiveness of internationally-coordinated policy actions.

Yet, in spite of these attainments, the global order remains unsettled in its institutional arrangements. Moreover, it is shaken by lacerating tensions fuelled by the resurgence of nationalism and protectionism, which are in turn rooted in the widespread dissatisfaction with globalization, the increase in inequality, both within and across nations, the growing threats to global commons, with climate change at the top of the list. Other factors too add to the risks of an outbreak of disruptive instability: long-standing global imbalances persist and worrying fragilities in the financial sector have resurfaced, originating from a return of traditional excesses that the post-crisis regulatory reform proved unable to prevent as well as from the very high level of private and public debt.

Against this backdrop, risks loom large of another episode of severe financial instability or, even worse, of an international crisis precipitating the end of multilateralism and the fragmentation of trade and finance into regional blocs. History has repeatedly shown humankind's inability to avoid repeating past mistakes – so that these adverse scenarios cannot be shrugged off relying on the guidance offered by past crises. Yet, the analysis sketched here has shown that, even if unsettled, the reform in global governance has improved the world's resilience through the increased flexibility and effectiveness of international policy action which the new tools can provide – *if* there is sufficient agreement to use them.

6. Key features of the new order

Although incomplete, unsettled, and under experimentation, the new order has a few well-defined features.

The **fragmentation** of many aspects of global governance is the **first** feature of the new order that is worth highlighting. Although some authors see fragmentation as a proof of the continuing absence of effective governance,⁴ most consider it as an inevitable component of a multipolar system,

³ The video https://www.youtube.com/watch?v=1yeA_kHHLow shows Rahm Emanuel, President Obama's chief of staff, uttering this phrase. Other attributions are also available, including to Winston Churchill.

⁴ For example Bremmer and Roubini (2011), and Temin and Vines (2013).

although with different gradations of optimism for the benefits it can bring to the effectiveness of global governance.⁵ It is argued here that fragmentation is the direct result of the unsettled nature of the reform in global governance. Fragmentation does *not* come from the intention to relinquish the pursuit of a cohesive institutional architecture. Among the evidence supporting this conclusion, one might recall emerging economies' struggle to increase their influence in the Bretton Woods institutions and their attention to the congruity of frameworks across international institutions, as illustrated by the cooperation between the AIIB and the World Bank.

In the absence of an off-the-shelf model of global institutional architecture adequate to the multipolarity that has emerged since 2008, the quest for a satisficing governance design has been actively pursued through a trial-and-error process. Yet, in spite of the important role of serendipity, the reform has maintained an overall consistency because of the **purposeful experimentation**, which is the **second remarkable feature** of the reform in global governance. Emerging market countries have led to the establishment of a host of new arrangements, which share a common characteristic: their potential to become the building blocks of a more accomplished and multipolar global architecture.

Another element has contributed to the consistency of the reform: the **interconnectedness** of the different elements shaping global economic governance, which is the **third noteworthy feature** of the reform. It originates from several factors: the greater awareness of the importance of the interdependence between different domains of global governance; the function of the G20 as the hub for many interacting international groups; and the wider access to global networks, as well as the closer interactions between them. All this is ultimately a reflection of the increased interconnectedness of economic and financial systems, which has reached an intensity unconceivable just a few years ago.

The dissatisfaction with globalization has been an important element of the public debate on economic developments for many years. This backlash and the relative debate, which is too articulated to be recalled here,⁶ are the fundamental motivations of the **forth notable feature** of the reform in global governance:

the **concern for inclusiveness** in economic growth. Although the notion of inclusive growth is given different interpretations both across the political spectrum and among different countries, it is by now recognized as an essential element for the sustainability of growth and the long-term viability of international arrangements.

One **final** feature of the new order is the impact on global governance of **the social media revolution**, given its pervasive impact on national politics and international relations. The study of the implications for social interactions and political processes of the huge increase in the accessibility of information is in itself a specific topic of investigation that garners growing scholarly attention.⁷ Yet two key implications/ channels can be identified.

The first one is the increased 'impatience' of policy makers: the real-time scrutiny and feedback, which they are subject to, constrain their attitude in international relations. Politicians have to show that their country 'won' every single piece of international negotiation. Conversely, international cooperation thrives on the repeated nature of commercial, financial and political interactions that offers scope for compromises across issues and over time. The second channel of influence originates from the much more diffused and unverified *production* of information. With an informed and articulated analysis of this phenomenon still in the making, one can only flag the issue of the growing importance of public *perceptions*, not always based on true facts, in setting constraints on the politically-viable outcomes of international relations.

7. A European coda

In this momentous transformation, Europe punched well below its weight. Even though Europe has obtained remarkable achievements in economic, financial and political integration, enshrined in the introduction of the euro, European countries have remained very jealous of their prerogatives regarding external relations. As a result, European external representation has always been weak, divided, and derivative with respect to national positions, even when strategic objectives were obviously coincident, as in the IMF or the G7.

⁵ For example, Helleiner (2016), Larinova (2016), Acharya (2016), Weder and Zettelmeyer (2017).

⁶ The reader is referred to Stiglitz (2017) for a recent (and opinionated) review of the debate on globalization.

⁷ See for example Sunstein (2017) and the literature quoted there.

The reform in global governance initiated by the crisis highlighted the inadequacy of the European position: at that crucial juncture, Europe missed the chance to influence the events in line with its economic size and potential geopolitical power. It was so absorbed by its internal disputes over the management of the sovereign crisis as to be unable to join forces and defend its own interests in the rebalancing of power within the G20 and in the negotiations about the reform of the IMF.

Europe's declining influence in the reform of global governance is not inevitable. The most compelling and expedient strategy to this end is to arrange a more effective representation in international fora and institutions by following, at the European level, the same approach that countries adopt in IFIs when they are jointly represented by the same executive director. This approach requires no change in domestic or international legislation, only political

goodwill. And it is no utopian proposal, as the recent decision to form a euro-area constituency in the AIIB has shown.

A more united Europe, capable of exerting significant influence on global economic and financial architecture would benefit not only Europe itself, but the whole world too. It would help the diffusion of the features of its social model, such as consumer protection, that can contribute to mitigating the costs associated with globalization, thus helping to preserve an open multilateral system. Moreover, a stronger Europe could contribute to the resilience and stability of the global economy reducing the risks associated with a governance based on a US-China bipolar system. Finally, a more united Europe could underpin the function of the euro as an international reserve currency, which could facilitate the orderly correction of the huge outstanding imbalances that pose a disquieting threat to global financial stability.

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