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Institute for International Business

Working Paper Series

RIIB Paper No. 19
July 2009

A Window of Opportunity Opens: Asian and American Views of the International Economic Architecture

This paper is published in *Asian Economic Policy Review* 4 (2)

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A Window of Opportunity Opens:
Asian and American Views of the International Economic Architecture*

By Wendy Dobson+

Abstract: This paper compares US and Asian views of the international economic architecture including Asia's evolving regional institutions. Lessons from the global financial crisis are used to assess reforms of the financial institutions better to prevent and manage future crises. While G20 leaders have increased the resources of the International Monetary Fund much work remains to restore its legitimacy and independence and to define clearly the Financial Stability Board's mandate to strengthen financial oversight and regulation. The paper critiques proposals for a global super-regulator and concludes that while the global architecture is important, the tests of its success will be fewer government actions to self-insure and the willingness to heed warnings of future problems and take timely corrective actions.

Key words: global financial crisis; international economic architecture; IMF reform; WTO; Asian regionalism; regulatory reform
JEL codes: F02, F13, F33, F55, F59.

***** The author is grateful for comments from Peter Drysdale, Jungwha Lee, Takatoshi Ito, Marcus Noland, Morris Goldstein, Kishore Mahbubani, Claude Barfield, Siow Yue Chia, Colin McKenzie and other participants in the Asian Economic Policy Review Conference on April 18, 2009 where this paper was presented.

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1. Introduction

Crises open windows of opportunity for policy and institutional reforms that fail to attract serious attention when economies are growing strongly. The global financial crisis and recession have opened such a window on the international economic architecture to strengthen incentives to prevent future crises and better manage those that do occur in ways that reflect the shift of the center of world economic gravity to Asia. Asian economies now account for half the world's population and nearly a third of global output measured at purchasing power parity, with Japan and China together accounting for nearly a fifth of total trade (Table 1). By 2020 the Asian Development Bank (ADB 2008) estimates, the region will account for almost half of the world's population and 34 percent of its output.

Reshaping the global architecture requires fresh approaches and leadership. The American and European architects created the Bretton Woods system around like-minded western industrial democracies in the vastly different cold war atmosphere after World War II. Asian governments participated in this system and were major beneficiaries of its openness. In the late 1990s they perceived these institutions no longer served their interests and began to pursue their own regional initiatives.

The crisis creates an opportunity to reshape the global institutions to reflect this increasing diversity. The world economy will contract in 2009 according to the International Monetary Fund (IMF) estimates and recover only in 2010, yet China and India will grow at positive rates despite steep declines (IMF 2009a). In contrast, output in the United States and Europe declined by 6 percent of GDP in the fourth quarter of 2008 and 12 percent in Japan. The G20 not the IMF was at the center of crisis management and prevention efforts.[i] The IMF (the Fund) was peripheral as the crisis unfolded, short of funds and unable to anticipate the potential systemic impacts of problems in the US housing and financial markets. In early 2009 governments moved the Fund back to the center by replenishing its resources and overhauling its programs as Iceland and small economies in Eastern Europe and beyond turned to it for financial assistance. Some also called for the Special Drawing Right (SDR) to become the world's super-sovereign reserve currency.

Within this context this paper compares US and Asian views of the international architecture for finance and trade. In the next section, views of the financial architecture are evaluated against stylized facts and lessons drawn from the crisis with respect to the Fund and the coordinating institutions for financial supervisors and regulators. Discussion of the World Trade Organization (WTO) follows. The third section evaluates the regional institutions being developed in Asia. The fourth section looks to the future identifying key issues in reform proposals put forward by Europeans, the United States and China. The fifth section concludes. The stakes are high. An open world economy has no natural guardian in a world of nation states. This openness will be sorely tested if growth momentum is not restored in the next eighteen months.

2. The international architecture for trade and finance: conflicting views?

The Bretton Woods institutions provide rules and principles consistent with opening markets and keeping them open. The foundation stones of the WTO and IMF are universal and aim to avoid any repetition of the political instability, exchange rate volatility, financial crises and commercial disruptions of the 1920s and 1930s. WTO principles of transparency, non-discrimination, national treatment, and reduction of trade barriers help to keep markets open while IMF principles of monetary cooperation, exchange rate stability, absence of exchange rate restrictions and assistance to address balance of payments problems promote the economic stability and openness necessary for trade to grow.

Generally, Asian governments accept these universal principles but, with the exception of Japan and India, argue the global institutions were created without their input and now lack legitimacy because governing structures fail to reflect the region's growing economic importance. They are not about to overthrow the institutions but neither are they waiting for them to be overhauled. As Mahbubani (2008) asserts, they have found their own ways to compensate for the weaknesses.

Both the IMF and the WTO were under stress before the onset of the current crisis, not because of their principles, but because of their flawed performance. The IMF was under fire over its handling of earlier financial crises and the WTO's future role was in question due to the difficulties of completing the Doha Round. Adding to the stress is the diversity of the emerging market economies, particularly China which is still poor, aging and authoritarian. Its size and dynamism make it an emerging economic superpower whose policies and performance increasingly spill over beyond its borders.

The crisis increased pressures both on the IMF and on Asia's regional financial initiatives. The crisis began as an asset bubble in the US housing market in which lack of oversight of the mortgage market and financial innovations played roles. Low-quality subprime mortgages were offloaded by originators as complex securities. These securities were widely distributed within the financial system, helped along by favorable but flawed credit ratings that in turn led to the widespread mid-pricing of risk. Unregulated non-bank financial institutions such as investment banks, hedge funds and private equity firms had grown rapidly in a macroeconomic environment of low real interest rates and lax credit standards. These institutions and the money center banks grew into large complex institutions, heavily leveraged, stretching across borders and reaching for yield. When US house prices stopped rising and the bubble burst the speed and magnitude of contagion across borders was swift and dramatic. As the credit freeze following the Lehman Brothers failure showed systemically significant institutions were considered too large to fail.

Many have analyzed and drawn lessons from the crisis.[ii] This paper applies six lessons in its assessment of views of the financial architecture. First, adequate resources are necessary to manage the impact of financial crises on small countries. Second, monetary authorities should prick asset bubbles before they burst and their mandates should include taking account of financial system stability. Third, banks are at the heart of national financial systems; increasing their capital and liquidity requirements during good times will reduce excessive leverage and risk taking in these systems. Fourth, regulation will continue to be national so consistent principles and standards of best international practice agreed and monitored at global levels are required to protect their stability and reduce their vulnerabilities. Fifth, coordination and information sharing, particularly on the inter-connectedness of large complex institutions should be stepped up at global and regional levels. Sixth, the too-big-to-fail problem must be addressed through timely intervention and effective loss-sharing formulas.

The application of these and other lessons to the mandates of the international and regional institutions and the implications for national governments will take place throughout 2009 and beyond. The IMF has a role in crisis prevention through its surveillance and early warnings but it is also the world's fire hall, the crisis manager that provides sufficient liquidity to extinguish the fires.

2.1 The International Monetary Fund

The IMF has had few fires to fight in the past few years, its resources were too small to make much difference in a world of large private capital flows and its expertise and legitimacy have been questioned as being an instrument of its major shareholders, particularly the US government.

2.1.1 IMF credibility and expertise

The 2008 crisis exposed the paradox that while cross-border capital flows have grown immensely global oversight of financial markets and institutions, macroeconomic policies and exchange rate regimes has declined. Initially, macroeconomic issues at the root of the crisis, the underlying savings-investment imbalance between the United States and China, received relatively little attention. US analysts argue that China's current and capital account surpluses, its emphasis on exchange rate stability and the buildup of foreign exchange reserves that supplied large amounts of global liquidity were the back drop for the excesses in the US financial crisis. Bergsten et al. (2008) assert that China's rejection of a flexible exchange rate policy is a challenge to the international monetary order. Chinese academics and officials recognize the advantages of greater exchange rate flexibility but stress the dilemmas in the conduct of policy. How to predict the speed of appreciation – or even whether more flexibility will result in appreciation? And what will be the relative impacts on exporters and importers if it does? Which export sectors will be most heavily affected? What will be the impact of import competition on China's farmers? "The structure of the economy is changing so fast, it is almost impossible to model the likely impacts with any certainty," as a Chinese academic put it.[iii]

These issues are at the center of the IMF's mandate yet it lacks the instruments and authority, other than its own analysis, to influence countries that do not borrow from it or who can self-insure as many central banks have done in the past decade. China tops the list with nearly $2 trillion in reserves in early 2009 (Table 2).

Instead the two governments pursued these and other issues in the bilateral Strategic Economic Dialogue (SED). The Fund and SED notwithstanding, imbalances were reduced by market forces rather than through coordinated action. The US current account deficit shrank between 2007 and 2009, from 5.3 percent to 2.8 percent of GDP while China's current account surplus dropped from 11.0 percent to 10.3 percent over the same period (IMF 2009c). As US households reduced consumption and began saving again import demand declined, cascading through global supply chains to the Asian economies causing dramatic declines in their exports. Public dissaving exploded as the US government rescued the banking system and stimulated domestic demand risking higher future inflation, an enlarged role of government and private sector crowding out.

2.1.2 IMF resources and crisis lending

The Fund's role as the world's financial fire fighter is unique but it has lacked the scale of resources to provide short term financing to countries in difficulty. At the time of the crisis its resources, at around $250 billion, paled in comparison with the world's central banks whose foreign exchange reserves totaled $5 trillion in 2007 and sovereign wealth funds who managed more than $2 trillion in 2006 (Truman 2007). Central banks led by the US Federal Reserve Board were also active in swap arrangements to address short term liquidity problems. The Fund is the logical candidate to deal with solvency problems where countries need to change their policies to solve their credit problems. Increasing the Fund's resources would assist it to do both. At their April 1, 2009 meeting G20 leaders authorized a one-time SDR allocation of $250 billion and $500 billion in new borrowing from its shareholders under the New Arrangements to Borrow (NAB). Japan and the EU each agreed to lend $100 billion to the Fund. China indicated its willingness to provide $40 billion in other ways. But without governance reform to give them more say other large emerging market economies were reluctant to participate.

2.1.3 IMF Governance

The IMF is governed by its members whose shareholdings and voting power were designed to reflect their significance in the world economy in 1944. No provisions were made for revising the structure to reflect changing economic circumstances. The pace of reform has been slow because the United States as the largest shareholder has been unwilling to provide leadership and reforms are resisted by small European countries whose relative significance has declined.

The Fund's legitimacy and credibility troubles began after the Asian crisis when it was criticized for giving inappropriate macroeconomic advice and insisting on structural reforms that encroached on domestic sovereignty. Ito (2007) argues that the IMF lost credibility when its advice helped to deepen the crisis by treating Asian borrowers with liquidity problems as if they were insolvent with structural problems. Resentful borrowers repaid their loans early and began self-insuring by accumulating foreign reserves larger than those needed to cover imports and short term liabilities. Takagi (2008) argues that the punishment meted out by Asian governments is more severe than the crime. It did better than its strongest critics allege, given what it knew and what it could do at the time. Its failure to acknowledge errors and rebut criticisms through open dialogue caused its problems, which implies they are remediable by changes in style and substance. DeGregorio et al. (1999) propose to address these problems by making the Fund's management more independent of its shareholders and their political interests in its analysis and advice and more accountable for its performance both to shareholders and the public, and by changing the voting structure to reduce the influence of the United States.

Such proposals raise the question of whether greater independence to restore Fund credibility is congruent with increasing its legitimacy by giving more voting power to the large emerging market economies. Insofar as one of the arguments for a greater say is to influence management behavior a restructured governing board with a less operational and more strategic focus could frustrate this objective.

2.2 Financial Market Oversight and Instability

A paradox of the crisis is that financial supervisory oversight is largely national while finance is increasingly global. The first principle of maintaining stability in financial markets is to strengthen domestic financial systems, but national regulators cannot prevent cross-border financial crises by acting on their own. They must coordinate and communicate among themselves. After the Asian financial crisis, G7 governments set up the Financial Stability Forum (FSF) to facilitate such cooperation. The FSF promotes efficient discussion but it lacks legitimacy and relies on voluntary implementation. When the FSF issues one of its excellent reports, who is responsible for seeing that the recommendations are carried out?

The IMF to some extent addressed this issue when it introduced its voluntary Financial Sector Assessment Program (FSAP) to upgrade surveillance and national financial supervision following the Asian crisis. But it did not coordinate with the FSF and its voluntary advisory approach meant that some large countries like the United States and China did not perform FSAPs until G20 leaders committed all members to carry them out. The question remains, however, whether the FSF and IMF who must still rely on voluntary implementation have the necessary authority to address such national weaknesses as inconsistent regulatory structures, lack of regulation of systemically significant institutions and lack of oversight of complex financial innovations.

2.3 The WTO

The global trade regime has key roles: to develop and enforce trade rules, to provide a forum for negotiating the reduction of trade barriers and to provide a platform for a credible dispute settlement mechanism. The focus of the Doha Development Round on the difficult issues left over from previous rounds may have seemed desirable when it was launched in 2001 but it magnified the political complexities of the negotiations. The Round's agenda has become increasingly marginalized by rising public concerns about climate change and green protectionism, rising commodity prices and financial instability. Business interest in the Round is difficult to find. Powerful farm lobbies in the United States and India played roles in the latest breakdown in July 2008. The G-20 leaders were correct to stress the dangers of protectionism in their November 2008 communiqué, but their solution – to try to re-launch the talks by year-end – set them up for their first failure to deliver when the effort ended without agreement.

Governments are predictably dusting off overt and covert protectionist measures as they seek to help troubled industries. In January 2009 the US congress introduced "buy America" provisions on some of its infrastructure spending which were later modified but only with respect to countries with which it has trade agreements. As many as seventeen G-20 countries have implemented measures that restrict trade. These measures include tariff and non-tariff measures such as Russia's tariff increases on used autos, Argentina's licensing requirements on a range of manufactured goods, India's ban on Chinese toys, as well as subsidies for troubled industries like autos (Gamberoni & Newfarmer 2009). At the other end of the spectrum the leaders of Japan, South Korea and China explicitly vowed at a December 2008 summit to refrain from protectionist measures.

Future prospects for the Doha Round are not promising. Regional and other free trade agreements (FTAs) are proliferating. Many are riddled with exceptions and offer small chances of actual gains from liberalized trade. Foreign policy reasons for negotiating frequently outweigh the economic rationale. There are few signs of a return to the disastrous beggar-thy-neighbor policies of the 1930s, indeed the protectionist measures noted above have received wide criticism and overall the trend is muted. But there is room within the WTO rules for countries to engage in incremental protection by raising tariffs that are below WTO target levels.

Efforts to revive Doha assume that trade liberalizing momentum must be maintained or governments will fall back into competition and protectionism. Some argue for abandoning the Round and adopting a new agenda that emphasizes transparent and non-discriminatory rules over liberalization. High on the list would be closing discriminatory loopholes in existing agreements and updating the rules to take account of new border measures such as carbon tariffs and border security measures (Sally 2006, 2008). Others argue for a more ambitious agenda. Threats to use traditional trade retaliation against countries perceived to retain trade advantages by dragging their feet in reducing carbon emissions have become a public concern. Subsidies that encourage the use of food grains to produce biofuels, thereby raising world prices and burdening the poor are another concern. Tackling under-valued currencies using WTO enforcement mechanisms that the IMF lacks has been suggested as has decentralizing future rounds since not all members are equally interested in all issues (Mattoo & Subramanian 2009). Expanding the number of WTO players has added to the complexity of the global rounds and some decentralization and phasing of liberalization to accord with the global rules may be more effective.

3. Asia's regional institutions in finance and trade

The East Asian economies have not waited for resolution of these issues. They are creating their own finance and trade arrangements centered on the Association of Southeast Asian Nations (ASEAN) founded in 1967. Market forces and unilateral liberalization have driven the region's rapid growth as regional production networks have tied the economies more closely together. More than half of Asia's merchandise exports are now shipped within the region. Since Japan initiated bilateral trade negotiations with Singapore almost a decade ago, other large economies have followed suit, both with regional partners and beyond. ASEAN members signed their own Free Trade Agreement (AFTA) in 1992 and have since pursued FTAs with the region's largest economies (Table 3). Singapore has concluded the most FTAs, followed by Japan and India. This FTA band wagon may be headed towards freer trade, but few of the FTAs actually liberalize much trade. Instead, the concern is growing that they are discriminatory (if they are enforced), complex and may discourage, rather than encourage, FDI.

With the proliferation of regional architecture summarized below and as the evidence mounts that many of these FTAs are riddled with exceptions and conflicting rules of origin, calls for a region-wide FTA are increasing.

In finance, the 1997-98 crisis crystallized awareness that much of East Asia's high savings were intermediated in the world's financial centers rather than in the region. One response was to develop regional bond markets. In 2003 the Asian Bond Market Initiative was launched to encourage local currency issues and the Asian Bond Fund created a pool of foreign exchange reserves from member central banks to increase liquidity. The other response was to develop a regional emergency financing mechanism using bilateral currency swap agreements among the members of ASEAN+3 through the Chiang Mai Initiative (CMI) which began in 2000. By 2009 these swaps totaled $120 billion with 80 percent contributed by China, Japan and South Korea. Plans were also finalized to pool these arrangements into a common fund with a governance and voting structure to make it accountable to its members.

These closer economic ties have encouraged Asians to "think Asian," indeed Wanandi and Yamamoto (2008) see the region as at a crossroads. As China and India emerge as economic powerhouses they will compete with Japan and each other for influence and leadership of the region – unless a serious commitment to community building creates common goals and incentives for closer cooperation. So far this activity seems to be focused more on members' interests than on advancing common standards and principles. In 2001 a high-level Vision Group proposed to create an East Asian community by 2015 with a framework for economic and financial cooperation that would lead to an East Asian FTA and an Investment Area. In 2004 membership was expanded over China's objections to include India, Australia and New Zealand in the East Asian Summit (EAS) with a focus on cooperation in energy and the environment. The United States is absent from these economic groupings, participating only in the Asia Pacific Economic Cooperation forum (APEC). It was not invited to join the EAS which is seen as the kernel of a community of Asians, much like the European Union is for Europeans and its involvement in the region has tended to emphasize bilateral links.

Where is Asian regionalism headed? Pulling the big players, particularly China, into cooperation in the region is a sensible strategy. Cooperative institutions serve China's objective of developing closer friendly relationships in the neighborhood and its desire to counter-balance US influence. India's inclusion provides a potential counter-balance to China. Good relationships with its neighbors also allow China to concentrate on its many distractions at home. When government representatives talk about China's "peaceful development" they are at pains to elaborate that this means "Three Nos:" no expansion; no hegemony and no alliances. The message also has an implicit sub-text: if China gets its domestic development right its influence will automatically expand with its growing economic and political clout. The cooperative networks also help to address the ambivalence that many feel about China, summed up by the observations of some Asian neighbors who say, "Don't call China a threat," while others admonish, "Don't forget China is a threat."

The long term value and viability of Asia's institutions will depend on support from the large players, on consistency with global institutions – and on results. What does China want? Its views are clearest in trade where its FTAs reflect foreign policy objectives rather than economic liberalization. China has also indicated its lack of interest in APEC proposals for a Free Trade Area of the Asia Pacific (FTAAP). More significant liberalization might occur in a Northeast Asian FTA being contemplated by China, Japan and South Korea, and in one between China and Australia. Progress is slow, however, since its trading partners are committed to comprehensive liberalization.

The proliferation of bilateral FTAs has created discriminatory arrangements, which as Park and Cheong (2008) show produce outcomes that are inferior to region-wide FTAs or to FTAs among the large countries. Baldwin (2008) identifies the "hub and spoke trap" into which smaller nations can fall in their negotiations with their larger neighbors. European experience shows that the trap can be avoided if the large countries agree among themselves on consistent templates to ensure coherent rules of origin in agreements with smaller countries. The ideal outcome of regional trade liberalization is a region-wide or trans-Pacific FTA. As quantitative studies have shown, the liberalizing gains increase with the size of the agreement. But there are political reservations about including the United States and India, which is less liberalized than its East Asian neighbors and could require the others to wait for it to catch up.

The G20 meetings were both a missed opportunity for regional responses to the crisis and a catalyst for future action. They were a missed opportunity in that governments acted on their own. The CMI swap mechanism was inactive; some even assert that if it is not activated by mid-2009 the initiative will be abandoned. National treasuries and central banks responded in uncoordinated fashion. There was no collective Asian strategy that pulled together the domestic, regional and global impacts of the large stimulus packages in China, India and Japan and other members. No prescriptions were forthcoming from the group and no targets for their own cooperation. There are several possible reasons such as China's reservations about the EAS and the fact that most Asian economies escaped the worst impacts of the financial crisis because banks' balance sheets were in good shape and households and businesses were not highly leveraged.

Yet the G20 was a catalyst for possible future regional cooperation. The membership of six Asian countries (Australia, China, India, Indonesia, Japan and South Korea, the "Asian 6") confers an expectation that they will think and act in the global interest. This expectation could translate into this or a sub-group providing more strategic leadership to replace the ad hoc activities of the past. A more strategic approach would serve at least two objectives. One is to rebalance the export-led growth in Asian economies with more regional and domestic demand. The other is to address the strategic implications of regional trade initiatives. Americans see the regional institutions at risk of becoming an exclusive bloc if tensions were to rise among the large economies or if there were a serious outbreak of US protectionism. Proponents of FTAAP such as Bergsten (2007) see it as a potential new driver of global trade liberalization capable of galvanizing action at the WTO and as a group within which the inevitable tensions between the United States and China can be more effectively buffered and addressed. FTAAP will not succeed if it is supported only by the United States. It has to be endorsed by Japan, China and India.

4. Looking to the Future

As the global recession continues the priorities are clear, to stabilize the world economy and change the international institutions to prevent future crises and better manage those that do occur. The nature and extent of such change is not agreed, however. French President Sarkozy advocates global regulation of capitalism, implying that governments should supervise and control global capital flows and the activities of market institutions more closely. No one questions the need to draw lessons from the crisis to improve how national and international systems function but designing new interventionist institutions before financial systems have been stabilized and the crisis' full lessons are drawn could produce the wrong outcomes that governments would have to live with for a generation or more. It is worth taking the time to get them right. G20 reforms have focused on the IMF to fight fires and on the FSF to reform international financial supervision and regulation. Activating Asia's emergency financing mechanism has been speeded up. The global trade architecture has remained intact; frequent warnings against protectionism have so far muted national responses. In Asia sub-regional FTAs continue to be pursued but rationalizing them into an Asian FTA seems inevitable. Only the route and timing are uncertain.

4.1 IMF Reform

The IMF has moved back to the center of systemic crisis management, particularly for small countries with the weakest policies and financial institutions who are most likely to be affected by the protracted deleveraging process that lies ahead. As the Fund's lending capacity has tripled it has responded directly to the predicaments of smaller countries by streamlining its lending framework and conditionality, providing adjustment support through a short term lending facility through which qualifying countries can borrow up to five times their quota on an immediate basis and creating a new credit line for well-run emerging market economies. There are two tests of these new arrangements: the speed with which they finance the immediate needs of countries in need of quick-disbursing credits and the adequacy of unconditional finance to reduce incentives for countries to self-insure by managing their exchange rates to build up foreign exchange reserves.

It is too early to draw definitive conclusions but Asian governments who self-insure continue to have strong reservations about relying on Fund advice and resources. Anecdotal evidence suggests that one of the reasons the CMI remained unused in early 2009 is because of its linkage to Fund conditions. Charges that the Fund is dominated by US foreign policy concerns can only be countered by strengthening its objective voice. Small countries have repeatedly indicated they find Fund surveillance and advice helpful even though large countries have tended to ignore it. Advocates of Fund objectivity suggest that the Fund present its policy critiques in more forceful ways and that management be very blunt with governments of larger countries (Eichengreen 2006). This is something it has been reluctant to do and indeed is not encouraged by the Executive Board.

If confidence is to be restored in the Fund's legitimacy, independence and expertise a number of changes are required. The methods of selecting top management are under fire as is its outdated governance structure. Future Managing Directors should be the best possible persons for the job regardless of nationality. The Fund's board should be reformed by redistributing its voting power, shrinking its size to reduce over-representation by European countries and changing the way governments interface with management to reduce their involvement in the daily work of the Fund. Fundamental to the size and power structure of a reformed board is a new formula for quota allocations and voting power that gives less weight to the United States and the European Union. Changes in shareholders' interface with Fund management would allow it greater objectivity and independence in its surveillance and early warning roles. Executive Directors might withdraw to their capitals, visiting Washington for regular board meetings on strategic issues and management accountability.

Governance reform should also align IMF governance with that in the G20. Eichengreen (2009) notes that membership of the Fund's governing body, the International Monetary and Financial Committee (IMFC), differs from the G20. Of the IMFC's 24 members seven are from the European Union. Other members represent groups of countries called constituencies. If the IMFC were to evolve into an oversight board focused on Fund strategy it would fit better with the G20 structure either by shrinking the IMFC's size or enlarging the G20 and organizing its membership into constituencies. Reorganizing the G20 in this way would reduce its unwieldy size. Such changes are also feasible because it is still informal and evolving; to make them only political will and leadership are needed.

These proposals are politically difficult but possible if the United States provides persuasive leadership to bring them about. If it were to give up its veto power, for example, it would be difficult for members of the European Union to refuse to rationalize their representation. The purpose of such changes is to accord more power to emerging economies like China, India and Brazil. But how will they use their clout? Will China support changes that give it more power while enhancing IMF staff independence? Will the United States and China be willing to move discussions of their macroeconomic interdependence into the IMF? China will be a big loser from future US inflation if the United States fails to remove in a timely way the liquidity pumped into the system during the crisis. The risks of future US dollar volatility and inflation are systemic concerns as well.

Reflecting China's concern, Zhou Xiaochuan, Governor of the Peoples Bank of China (Zhou 2009) proposed to establish the SDR as the world's reserve currency arguing that the current arrangement which relies on a national currency is flawed because of the potential for conflicts between domestic goals and international responsibilities. As the dollar-based system has become more volatile, developing and emerging market economies have diverted foreign exchange reserves from more productive uses to self-insure. The idea merits consideration and was also advanced by the United Nations-sponsored Commission of Experts on Reforms of the International Monetary and Financial System chaired by Nobel Laureate Joseph Stiglitz (United Nations 2009). The Commission recommended a new global reserve system, such as a greatly expanded SDR calibrated to the size of reserve accumulations, to head off an expected evolution towards a two- or three-country reserve system which they assert would be as unstable as the current US-based system. Bergsten (2009) argues that the merit of China's proposal's lies in its potential to allow large holders of US government securities to diversify their holdings within the IMF thereby avoiding exchange market volatility. Even so, the proposals are unlikely to gain much traction in the short-term as market participants have little enthusiasm for the SDR and few governments have show much official support.

In summary, IMF reforms are moving in the right direction but those most important to its future effectiveness -- increasing its independence and its voice to provide credible advice and early warning to governments – have yet to be implemented.

4.2 Strengthening financial regulation

Stronger regulation and supervision of financial systems is essential to prevent future crises. The need for closer international cooperation was recognized after the Asian financial crisis when the Financial Stability Forum was set up by G7 governments. It is supported by the Bank for International Settlements and convened in 1999 with the participation of G7 national financial authorities, international financial institutions and regulators and supervisors' groups. Its best practice guidelines for financial sector supervision and its promotion of cooperation across standard-setting bodies are useful first steps but the crisis has demonstrated that much more is required to encourage voluntary compliance by national governments and to establish global principles of best practice to reduce weaknesses revealed by the crisis. Recognizing the FSF's expertise, G20 leaders expanded its membership to include all G20 members, changed its name to the Financial Services Board (FSB) and charged it to work closely with the IMF on implementation of its recommendations and guidelines through the Fund's surveillance programs.

A major issue going forward is whether global financial supervision should be centralized in order to address effectively the information gaps created by cross-border financial flows and the too-big-to-fail problem. The UN Commission proposed both a Global Financial Authority and a Global Competition Authority on the grounds that more effective global cooperation and financial regulation than that provided by the FSF are required to deal with financial institutions that are too big to fail. Eichengreen's (2009) proposal for a World Financial Organization analogous to the WTO is more decentralized. Membership would be obligatory for countries whose financial institutions wish to engage in cross-border activities. The organization would have a charter and supplementary agreements that set standards and rules for supervision and regulation. Each member would decide how to meet these obligations, leaving them room to tailor regulation to the structure of their financial markets. An independent body of experts analogous to WTO dispute settlement panels would monitor whether countries have met their obligations and impose penalties for poor performance.

The reality, however, is that governments are unwilling to cede sovereignty to a global super-regulator. Good regulation begins at the national level by strengthening domestic financial systems with prudential oversight of banks, nonbank financial institutions and insurance companies to ensure their safety and soundness. The size and reach of global regulators cannot make up for the local knowledge and judgment of national regulators who must be very knowledgeable about the institutions they oversee. Nor is there any one model for a national financial supervisor. The UK model of a single independent regulator failed to prevent a crisis in which the banks had to be temporarily nationalized while the decentralized arrangements in the United States had severe short comings as well. Large complex institutions like Citigroup, with an entire floor of supervisors onsite, were at the heart of the financial crisis.

With regulation and supervision at national levels, there are several priorities for global supervisory institutions: to establish principles and standards of best practice; to deepen coordination and information flows to prevent the high levels of leverage and the concentration of risk which were also at the heart of the crisis; and to develop and apply effective methods of intervening in and resolving large troubled financial institutions. As well, early warning systems are needed at global, regional and local levels.

Measures to strengthen global financial supervision are still evolving. The effectiveness of the FSB will depend on the willingness of national governments and regulators to deepen their coordination and improve their monitoring of cross-border flows and the activities of inter-connected institutions. In the end, much will depend on governments' will to heed warnings of potential problems and to take timely action.

4.3 Asia's Regional Institutions

G20 membership as noted earlier could be a catalyst for Asian regionalism. Much of the energy that has been expended on membership in Asia's variable geometry might in future be better focused on the substance of common frameworks. The Asian 6 are now on an equal footing in a global forum which could encourage them, particularly in finance, to adopt common regional standards and principles that are consistent with global frameworks. A group of eminent economists has recommended intensified supervision of financial institutions engaging in cross-border business and an Asian Financial Stability Dialogue to deepen regional financial integration (Asian Development Bank Institute 2009). Such an initiative could also provide a regional forum for monitoring and peer review of the stability and vulnerability of national financial systems.

In trade, the numerous sub-regional trade negotiations have increased governments' experience with reciprocal bargaining, something that was lacking in APEC's trade liberalizing efforts in the late 1990s. These might be resurrected during the 2009-2011 period when Singapore, Japan and the United States host a sequence of APEC leaders' meetings. Negotiation of a comprehensive FTA should be explored that builds on the Trans-Pacific Partnership negotiated by Singapore, New Zealand, Chile and Brunei Darussalam, which the United States applied to join in 2008. Such an initiative could provide the basis for a variable-speed liberalization process that begins with a core group and is open to others who later decide to join.

5. Conclusions

Macroeconomic coordination among G20 governments prevented the collapse of the international financial system. Going forward the central lessons of the crisis are being applied but there is more to do. IMF resources will be sufficiently enlarged to help small countries but its legitimacy and independence, which have not yet been fully addressed, will be tested by whether countries continue to self-insure. Financial supervisors and regulators will work together in the FSB and are expected to coordinate more closely in applying the principles of best practice, in monitoring of risks to future financial stability and in taking prompt corrective action when required.

These changes in the global architecture are important but the *sine qua non* is that systemically significant countries listen to the global institutions and act in timely ways to prevent future crises. More equal representation on the IMF is vital to this outcome. Clear mandates and adequate resourcing (including leadership and staffing by highly skilled and experienced people) of these institutions are also essential.

Looking to the future, with less leverage in the system future economic growth will be slower and more sustainable. But other systemic risks lie ahead as a result of the unprecedented actions taken to manage the crisis. Government ownership of banks and fiscal and monetary stimulus in the United States and Europe have increased the risks of moral hazard, future inflation and crowding out. As debates about reversing these actions move up national and international political agendas the political will to implement fully the reforms discussed in this paper could be seriously tested.

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Table 1. Selected Economic Indicators, 2007 (in percent)

Country	**Share of world GDP[a] at market exchange rates**	**Share of world GDP[a] at PPP exchange rates**	**Share of world trade[b]**	**Population[c]**
United States	28.0	22.5	16.0	4.6
Japan	10.3	7.0	6.8	2.0
China	5.0	9.6	11.2	20.0
India	1.7	4.2	1.8	17.0

Notes: a/ 2005 values; b/ sum of imports and exports. Intra-EU trade excluded from world total; c/ 2006 shares.

Sources: Asian Development Bank (2008); UN Comtrade data base; World Development Indicators (2008).

Table 2. Official Reserve Assets (March 2009)

Country	Reserve Assets (Millions of Dollars)
China	1,953,741
Japan	1,084,774
European Union	526,750
Singapore	166,099
India	252,235
Hong Kong	182,315
United States	75,267
United Kingdom	79,152

Sources: "Time Series on International Reserves and Foreign Currency Liquidity, IMF (available at www.imf.org/external/np/sta/ir/802P816.pdf); State Administration for Foreign Exchange available at http://www.safe.gov.cn/model_safe_en/tjsj_en/tjsj_detail_en.jsp?ID=30303000000000000,18&id=4).

Table 3. Asian FTAs, country rankings

(As of December 2007)

Rank (by actual)	Country	Actual or under negotiation	Actual (concluded)	Total (including proposed)	Inside Asia
1.	Singapore	21	11	26	6
2.	Japan	15	8	30	12
	India	18	8	30	8
3.	PRC	13	7	22	8
4.	Thailand	12	6	18	7
	Korea	11	6	22	9
Sub-total		90	46	148	50
ASEAN		6	2	6	4
Total		93	49	204	80

Source: Asian Development Bank, 2008, Table 3.4.

Endnotes

[i] The members of the G20 include Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, United Kingdom, United States and the European Union.

[ii] There are many publications and reports on causes of the crisis and lessons to be drawn, such as Calomiris (2009), Dewatripoint et al (2009), Goldstein and Xie (2009), Group of Thirty (2009) and IMF (2009b).

[iii] Personal interview, July 2008.