

6-1-2009

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## Recommended Citation

Bradlow, Daniel. "Reforming the Global Financial Architecture: Is Real Change Coming?" (working paper June 1, 2009)

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## Reforming the Global Financial Architecture: Is Real Change Coming?

Daniel Bradlow<sup>1</sup>

“Global financial architecture” is shorthand for the institutional arrangements for governance of the international financial system. They include organizations like the International Monetary Fund (IMF) and the World Bank (WB), as well as more technical entities such as the Financial Stability Board (FSB) and the Basel Committee of Banking Supervisors (Basel Committee). It also includes a range of state groupings, of varying degrees of influence and cohesion, like the G7, G10, G20, and G24.

At least since the Asian financial crises, there has been general agreement that the global financial architecture needs to be reformed. However, the attention paid to this topic has been inversely proportional to the wellbeing of the global financial system. Consequently, the issue has recently received considerable attention. The first signs of this were the agreement at the 2006 IMF Annual Meeting to reform IMF governance. The agreed measures included small increases in the quotas (and therefore votes) of China, Mexico, Turkey and South Korea, and additional support for the African Executive Directors. Some of these reforms entered into effect in 2008. Last year the WB agreed to create an additional African Director, although this has not yet been implemented.

Not surprisingly, the issue was also on the agenda of the G20 summits in Washington and London. In fact, most of the commitments agreed at the London summit relate to this topic. It is also the focus of 2 high level commissions – the Manuel Commission studied the IMF’s governance and the Zedillo Commission is currently reviewing governance of the World Bank.

These developments suggest that now is an opportune time to take stock of what has been achieved and what potential exists for further reform. In order to do so, we need to answer 4 questions: What are the problems with international financial governance? What has been achieved? Are these reforms sufficient? What more can be achieved?

### *What are the Problems with the Institutions of International Financial Governance?*

There are 3 sets of problems with the existing international financial architecture. The first is the failure of existing global regulatory bodies. For example, the Basel Committee spent years developing new capital requirements for banks (“Basel II”). However, the current crisis demonstrated that these capital adequacy rules placed undue confidence in the capacity of banks to self-regulate and inadequately accounted for all the risk exposure of the banks.

Second, the legitimacy of the institutions themselves is impaired. Most significantly, the distribution of votes and voice in the IMF and WB has not kept up with changes in

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the global political economy. For example, Belgium has more votes in the IMF than Brazil; and Sub-Saharan African countries, which actually use the services of the WB, currently has 2 representatives on its Board, while Western European has 8.

Third, the conditions attached to IMF and WB funding are too onerous. For example, the IMF has historically required member states facing a financial crisis to cut public expenditures, unlike the strategy currently adopted by the US and Europe. In addition, some of the conditions, such as those relating to public sector management reform seem to be outside the IMF's macro-economic mandate or to violate the prohibition against the WB taking political considerations into account in its operations. One result is that many member states built up large reserves in part to ensure that they would never need IMF financing. This approach in turn helped create the global imbalances that contributed to the financial crisis.

#### *What Reforms Have Been Agreed To?*

The reforms can be divided into 3 areas. First, are those reforms that have been or are being implemented, three of which are of particular interest to Africa. The first is the conversion of the Financial Stability Forum into the Financial Stability Board. The FSF was the forum in which the banking, finance and insurance regulators from the G7 countries plus representatives from international financial institutions like the IMF met to discuss financial regulatory matters. The FSB adds the financial regulators from the other G20 countries to this grouping. This should result in broader participation in deliberations about financial regulation. However, it is not clear that the FSB will be more responsive than the FSF to the concerns of low income countries.

The second is the creation of the Committee of Ten African Finance Ministers and Central Bank Governors. The Committee includes Finance Ministers from South Africa, Nigeria, Egypt, Cameroon and Tanzania and Central Bank Governors from Botswana, Kenya, Algeria, West African States and Central African States, as well as representatives from the African Development Bank, the African Union Commission, and the Economic Commission for Africa. It was created to help South Africa, the sole African representative on the G20, prepare for the G20 meeting. While this grouping is informal and ad hoc, it is a useful forum for coordinating African positions for other international financial meetings, sharing information, and for developing protocols to guide African states in enhancing national financial governance.

The third involves the IMF's finances. The proposed reform has 3 components. The first is increasing the resources of the IMF by \$500 billion. By mid-April, the IMF had already secured approximately \$250 billion from Japan, the EU, China, Canada, Switzerland, Brazil, and Norway and was expecting to receive additional support from the US and other G20 member states. These contributions are in the form of loans (through the New Agreement to Borrow) and not permanent increases in the resources of the IMF. The IMF has not yet publicized the terms of these loans.

The second is the G20's support for a new \$250 billion SDR allocation (Special Drawing Rights are created by the IMF to provide member states with additional liquidity.) Pursuant to its rules, the IMF must allocate SDRs among all its members

on a pro rata basis. Consequently, developing countries will receive about \$100 billion, of which low income countries get about \$19 billion. It is possible that rich countries will decide to redirect their share of the SDR allocation to developing countries. In many countries such a decision, because it involves a commitment of state resources, will require legislative authorization, which is inherently uncertain.

Third, the G20 agreed that the IMF should sell some of its gold reserves to raise funds (approximately \$6 billion) for the poorest developing countries. These gold sales have already been authorized by the IMF membership, and so its implementation should be relatively easy.

The IMF has also taken a number of actions that are designed to enhance access to its financing. These include reforming its conditionality requirements so that they are more targeted and streamlined; eliminating some under-utilized facilities; creating an unconditional Flexible Credit Facility that will only be available to certain member states; and raising the limits on member states' access to IMF financing. The WB has also agreed to increase its lending over the next 3 years.

The second area is reforms that have been proposed but not yet implemented. These include an agreement that future heads of the IMF and WB will be selected on the basis of merit and not nationality. The G20 also agreed to implement all the voice and vote reforms agreed in 2008 and to advance the quota review scheduled for 2013 to 2011. Despite their agreement, it is unclear when and if these reforms will be implemented. The key problem is that the European states that are "over-represented" in the organization are unlikely to surrender their votes (and therefore agree to quota reforms) without compensation and it is unclear how they can be adequately compensated.

The third area of reform consists of issues that are still under discussion. The most significant of these are the recommendations of the Manuel report and the forthcoming recommendations of the Zedillo Report. In the case of the Manuel Commission, the recommendations include changing the requirements that the 5 largest member states have their own IMF Executive Director, changing the scope of IMF surveillance to make it more comprehensive, and changes in the majority voting rules to eliminate the US veto. These proposals require amendments to the IMF Articles. Since adoption of such amendments requires parliamentary approval in many member states, it is very difficult to predict if and when they will actually be implemented. One indicator: after 12 years, the Fourth Amendment to the IMF Articles has not entered into force because, despite the support of over 100 member states holding over 70% of the total IMF vote, it has not yet received the 85% majority needed for adoption.

#### *Are These Reforms Adequate?*

The goal of these reforms efforts should be to improve the institutional arrangements so that they are both responsive to the changing needs of the international community and are sustainable. Unfortunately, when measured against this standard, the current reform efforts are inadequate for 3 reasons. First, we are undergoing a shift in power in the global political economy. Currently, the rising powers are not powerful enough to successfully demand substantial reform of global financial governance

arrangements and the declining powers can still block changes that are not to their liking. Thus, the rising powers have only succeeded in obtaining marginal changes in IMF quotas, and the rise of the G20 has not yet led to the demise or even reform of the G7. The governance reform process is unlikely to be sustainable until this shift is more complete.

Second, the key challenges for global financial governance include, in addition to more traditional financial issues, the environmental crisis and the growing problems of poverty and inequality, which both impact global financial flows and financial regulation. Consequently, their exclusion from discussions on international financial governance undermines current efforts to reform the international financial architecture. One indication: some developing countries are refusing to make commitments on curbing carbon emissions until the rich countries clarify how much funding they are willing to contribute towards helping them deal with climate change.

Third, the current reform efforts have not addressed all the legitimacy problems in the institutions. For example, there has been no agreement on increasing the accountability of the IMF management and staff or on enhancing the ability of all stakeholders to participate in its operations.

#### *Next Step: Planning for Future Reform*

It is clear that civil society will continue to advocate and work for further reform of the global financial architecture. These efforts should be supported by African countries. If they succeed they will facilitate more effective African participation in the decision making processes of these institutions, thereby making the institutions more responsive to African interests.

However for these efforts to advance African interests, African states and civil society need to become effective participants in them. This requires key African actors to both develop a realistic reform strategy and energetically advocate for it. Such a strategy should include both short and medium term aspects. The short term aspects must acknowledge that the current institutions will continue to exist for some time to come and be governed by their existing Articles. Within these constraints, the strategy should focus on getting more effective African representation in the organizations and on improving channels of communications between these representatives and all African stakeholders in the organizations. It should also promote stronger mechanisms of accountability for the organizations. The history of the inspection mechanisms in the multilateral development banks demonstrates the importance of effective accountability mechanisms.

The medium term strategy should be more ambitious and should not accept as given that the current institutions must continue existing. Consequently, it should include a blueprint for the kinds of institutions Africa needs at a global level and a strategy for achieving this objective. A full elaboration of this blueprint is beyond the scope of this article. However, it is clear that the organizations Africa needs must have clear mandates that comprehensively address all aspects of international financial governance, transparent operational policies and procedures, effective accountability mechanisms and must provide for meaningful participation by all stakeholders.