The G20's Role in the Reform of the International Monetary System: Present Record, Potential, and Scenarios

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INTRODUCTION

With the acceleration of globalization, global markets have experienced an historic period of rapid expansion. The expansion of these markets has unleashed prosperity gains around the globe, most recently in large emerging market economies. However, it is now clear that this economic globalization has far outpaced the development of matching global governance institutions and rules, particularly in the arenas of finance and monetary systems (Rodrik 2011). The 2008 global financial crisis and the ensuing years of financial volatility have brought home the deficiencies in the architecture of governance undergirding global financial markets (Stiglitz and Members of a UN Commission of Financial Experts 2010). Furthermore, the 2008 crisis also highlighted the inherent instability of a global monetary system that relies on one currency (the USD), when this reliance generates large destabilizing inflows of capital into the US market and when the sovereign in charge of this global currency manages it as a purely national currency (Eichengreen 2011).

In this increasingly volatile and uncertain context, it is crucial that

systematically-large powers cooperate on two major fronts: the coordination of their macro-economic policies to prevent destructive zero-sum game behaviors; and the advancement of global institutions to monitor and stabilize global financial markets. In addition, in periods of crisis, great powers must also act together to manage key episodes, such as the recent Eurozone difficulties. In fact, the G20 Leaders Summit was created in November 2008, in part, to secure these three key areas.

Has it worked? What have been the key achievements of the G20 in terms of policy coordination and institutional development? What has been accomplished so far in terms of management of the international monetary system (IMS)? And where success has not yet been attained, what are some possible avenues for further progress?

This article analyzes the results, constraints, and potential of the G20 process so far. It argues that more attention should be given to the rebalancing and institutionalization of the IMS, even though it is a complex issue area, and one where optimal arrangements are hard to design and where key powers suffer from conflicting national interests.

The article proceeds in four steps. Section I reviews the results, potential, and limits of the G20 process as whole. Section II analyzes the dilemmas and limits of the current IMS. Section III offers some long-term avenues for reforms of the IMS through the G20. Section IV discusses the feasibility of these proposals and reviews possible scenarios.

WHAT ROLE IS THERE FOR THE G20 IN GLOBAL ECONOMIC GOVERNANCE?

G20 Summits have achieved significant but limited results so far

The G20 initially came into existence in Berlin in 1999 as a gathering of

finance ministers and central bankers. As an informal dialog mechanism under the umbrella of the Bretton Woods System, this G20 was composed of the eight member countries of the G8 (the US, Japan, Germany, France, the UK, Italy, Canada, and Russia), Australia, ten large emerging market country economies (China, India, Brazil, Indonesia, Mexico, Korea, Turkey, Saudi Arabia, South Africa, and Argentina) and the European Union (EU). The G20 Leaders Summit (G20 Summit), however, was created only in November 2008 at the onset of the global financial crisis. This new "high table" for global governance includes the same nineteen countries together with the EU, but at the level of heads of governments. These twenty entities represent 87% percent of the global GDP (as of 2009) and 65% of the world's population.[1] Since that time, the G20 Summit has become an important platform for global economic governance, international policy coordination, and importantly a setting for the reform of the international monetary system.

The first G20 Summit was held in Washington on November 15, 2008. It was followed by a series of summits in London, Pittsburgh, Toronto, Seoul, Cannes, and Los Cabos. The eighth G20 Summit will take place in St. Petersburg, Russia in September 2013. These initial seven G20 Summits have achieved four main results.

First, they have ensured a higher level of international coordination and cooperation among these largest global economies. This is reflected by the coordinated response to the global financial crisis; the combat against trade protectionism; the initial coordination of fiscal stimulus; and the gradual reduction in fiscal deficits in developed economies. Additionally since 2010, G20 leaders

[1] Source: Euromonitor International. http://blog.euromonitor.com/2009/04/g20-in-focus.html

have tasked the IMF with mutual assessments of the influences of respective policies on other states. Furthermore, leaders have provided for the publication of spillover reports, with the aim of promoting a robust and balanced global recovery.

The Summits have started to examine the reform of the governance of international financial institutions. The G20 has played a role in the transfer of IMF and World Bank (WB) voting rights to developing countries, so as to increase their representation and voice in line with their rising share of global GDP.

Third, the Summits have worked to strengthen international financial supervision. The G20 is responsible for the creation of the Financial Stability Board (FSB), which is tasked with the creation of global financial standards and the monitoring of global financial risk (along with the IMF). The measures taken by the G20 also include incorporating financial derivatives, hedge funds, and offshore financial centers – identified as "shadow banking" – into the scope of supervision. In addition, the G20 has discussed reforms in the remuneration system for senior executives of financial institutions, establishing global macroeconomic prudential management, and giving birth to the Basel Capital Accord III (Basel III).

Fourth, the G20 Summit has been institutionalized as a regular mechanism since 2011. The next Leaders Summit will be held in Russia in September 2013, followed by Australia in November 2014, and Turkey in 2015.

The G20's potential to improve global economic governance

A meaningful reform of global economic governance needs to go further than what has been achieved to this point. It must tackle, in our opinion, the following five issues:

In order to strengthen the coordination of international economic policies, the established economies should lead by example and resolve their internal

growth, employment, and trade imbalances through structural reforms.

In order to expedite the reform of the international financial system, the international community needs to push for the development of an international reserve currency system that emphasizes a stable, consistent supply: an improved international financial supervision framework which includes a tighter supervision of hedge funds, over-the-counter derivatives, and credit rating agencies; and an increase in the representation and the voice of the developing and large emerging market countries in international financial institutions.

There should be further liberalization and facilitation of international trade and investment. In order to fulfill global poverty reduction and development goals, more support for the improvement of education and social security in developing countries is needed. Some of this support may come from official development aid (ODA) from established economies (fulfilling a longstanding international commitment of ODA at 0.7% of national income). Yet, other sources may also be required, particularly in the context of economic and political crises at home.

In order to narrow the gap between developed and developing economies, G20 mechanisms should work towards stimulating international trade and investment, and transfer funds and technologies towards developing economies while supporting their industrialization and urbanization. This should also stimulate economic growth and create job opportunities in developed economies, thereby creating opportunities for all.

In order to address such structural shifts in the global political economy, there is a need for the G20 to be upgraded as a key coordination tool among large economy nations. Indeed, the G20 should gradually shift its focus from financial crisis management to the prevention of financial crises and the stimulation of a robust, balanced and sustainable global economic growth. The G20 could also lend critical support to the IMF in resolving global economic imbalances, reforming the IMF's administration system, creating a stable, long-acting

mechanism to settle international friction and promoting a balanced system of the international trade. Most importantly, there is a need for the G20 to provide mutual coordination between domestic and international policies. The G20 is also in a position to help further the transparency of national economic data and reduce the possibility of future economic crises.

A well-functioning multilateral trade system and multilateral monetary system is essential to promoting global economic rebalancing. Thus, beyond a focus on strengthening the international monetary system and balancing international trade, the G20 should focus on finding a way to establish rules that carry binding power and promote fiscal balance globally. At the same time, the G20 should monitor the global economic cycle and provide enough information to help prevent the repeated outbreak of financial crises. However, in the event that nations fail to reach a consensus on the rules to adopt, different nations should set some rules for themselves, for example by specifying the maximum proportion of long-term government debts in the domestic gross products (GDP) or defining the appropriate range of exchange rate fluctuation to ensure a balanced economy and stable development.

The G20 should safeguard the mutual interests of nations with different economic structures. First, the established economies should shoulder more responsibility, while large emerging market countries and developing states should actively work to expand their domestic demand and transform their pattern of economic development. Second, for these countries, in particular those with serious fiscal deficits, they should perform structural reforms. Their macroeconomic policies should focus on stimulating investments in fixed assets and human capital, rather than encouraging speculative investments in securities market and unsustainable excessive consumption. Third, the G20 must restrict the tendency for beggar-thy-neighbor monetary policies, and continue to oppose competitive currency devaluations. The G20 should then promote the reform of

the international monetary system. The G20 should formulate concrete measures to prevent trade protectionism. Members should speed up the institutionalization of the G20 mechanism and push for the creation of a G20 Secretariat which relies on IMF. Finally, new rules should be established in decision-making procedures; in an effort to expand the G20's role, gradually increase the scope of public goods it can provide, such as action in the fight against climate change and issues related to the future development of the economy, finance, and global trade. These are not easy tasks and the G20 suffers from serious limitations in facing them.

Today the Leaders Summit faces many challenges

Originally created to facilitate a coordinated response to the global financial crisis, the G20 has gradually evolved into a setting for the international community to coordinate important economic affairs. However, the G20 mechanism remains an informal institution and continues to face a multitude of challenges. One of the continuing challenges faced by the G20 is having to juggle the particular national interests with the broader objective of improving the health of the global economy and serving the international community.

The global economic context has been particularly difficult for the G20 process in the last three years. Paradoxically, post-2010 global recovery has been strong enough to weaken the sense of urgent crisis, but weak enough to erode a general sense of economic security and solidarity. The European debt crisis hangs over the world economy and creates added uncertainty. In this context, the threat of trade protectionism continues to affect the global economy. Global imbalances and recovery gaps further weaken the impetus toward further cooperation.

In this context, the following problems continue to plague the G20 process:

a) The lack of G20 authority and missing representation;

b) Conflict between established and large emerging market countries;

c) Strains in the international architecture and leadership created by the

changing global balance of power and the rise of a multipolar world; and

d) A weak process of reform of the international monetary system.

The frequent outbreak of financial crises is attributable in part to the failure of the international monetary system – and the maintenance of the USD as the sole reserve currency. One of the most urgent tasks for the G20 is to resolve outstanding imbalances in the international monetary system and global economic governance mechanisms, as they can no longer be based on the interests of the established economies alone. Indeed, major international reserve currency issuers must be accountable to a newly agreed set of international rules. The G20 mechanism should bring different countries to find a common perspective and solve problems of global common interests, thereby promoting a "win-win" approach.

THE LIMITS OF THE DOLLAR-CENTERED INTERNATIONAL MONETARY SYSTEM

The fundamental features of the current international monetary system

The international monetary system (IMS) has survived through the global financial crisis, but the crisis has also highlighted some shortcomings:

First, the US dollar is the core of the current international monetary system. As of 2011, 85% of international transactions include the USD as at least one of the transaction currencies and 61% of international reserves are in USD (Eichengreen 2011). This overwhelming weight should be contrasted with the share of the US economy as a percentage of the world economy (23%, based on 2010 figures in nominal USD).[2]

[2] Source: World Bank. World Development Indicators for 2010. http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP.pdf

In 1973, the United States unilaterally abandoned the Bretton Woods system. After a few years of the market turmoil, the international monetary system gradually returned to the dollar-dominated system. After the mid-1970s, there were only a few international currencies that continued to float against the USD, including the German Mark (later the Euro), Japanese Yen, British Pound, and Swiss Franc. However, currencies of large emerging countries were not internationalized and they were forced to peg to the USD. After the Asian financial crisis in 1997, the East Asian countries restored the exchange rate policy of pegging to the USD, and hence strengthened the central status of the dollar.

Second, the current USA-dominated international monetary system is basically a "3-ring structure". The United States is the "core country" as it is located in the center of the structure. To some extent, the US Federal Reserve acts as the "global central bank" because its monetary policies have dominant power and the privilege to artificially export the USD. Countries that adopt floating exchange rate regime, known as intermediate floating exchange rates, are located in the middle of the ring structure, including the European Union, Japan, Canada, Australia and some other Latin American countries: they rarely intervene in the foreign exchange market (with some exceptions, particularly Japan). The last group is called "peripheral pegging countries:" economies that adopt fixed exchange rate regimes and are located at the outer layer of the ring structure. These countries include China, South Korea, Hong Kong, Taiwan and Southeast Asian countries. These countries hold a large amount of foreign exchange reserves including USD. The structure of the current international monetary system is shown in Figure-1.

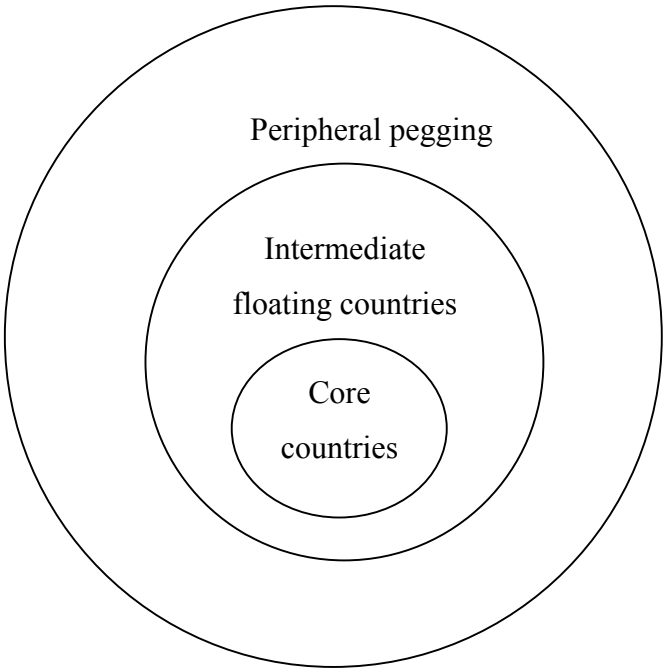

Figure 1: Current international monetary system as a three-layer "ring structure"

More importantly, there is no effective global adjustment mechanism to resolve global economic imbalances. Despite the status of the US as anchor for the global monetary system, the US central bank, the Federal Reserve is strictly mandated to set its monetary policy with consideration for US inflation, growth, and employment only. There is no channel for inputs from the rest of the world in managing the world's currency. Thus, the major international reserve currency issuer continues to implement quantitative easing monetary policies in light of the needs of its own economy without considering the global spillover effect of such policies. These policies have caused inflationary pressures on emerging economies, and in turn increased the systemic risks of the global financial system.

One enduring issue in the global monetary system has been the increasing volatility in global exchange rates, a volatility that cannot solely be explained by

changes in fundamental variables (inflation, interest rates) among countries (Shiller 2005). The role of international speculative capital has played an increasing role in the large fluctuations in exchange rates. Cross-border capital flows have fluctuated far beyond the global output or trade levels. Because of scarce global liquidity in the event of systemic crises, different countries have been pushed to accumulate foreign reserves to seek "self-insurance", which has aggravated the global economic disequilibrium. There is no coherent set of capital regulations at the international level, which allows different countries to implement distinct economic policies, based on their domestic conditions.

In the international monetary system illustrated in the Figure 1, the three groups are in unequal positions, and the relationships between them differ. Specifically, "core countries" and "intermediate floating countries" interact with each other mainly through the capital account, while "core countries" and "peripheral pegging countries" interact with each other through the current account. Consequently, the US and Europe have become financial partners while the US and Asia have become trading partners. To change the pattern of global economic imbalances, it would require multilateral coordination and giving greater play to the role of the G20, International Monetary Fund (IMF), World Bank, and World Trade Organization (WTO). Bilateral "games" between China and US will not be able to effectively balance the interests of the three groups in the "ring structure." Therefore, multi-level and multilateral coordination is needed to adjust the interests of the three groups.

The status of the US dollar as international currency and its impact on global imbalances

Since the establishment of the Bretton Woods system in 1944, the US has acted as the "core country" in the international monetary system, while also pursuing its own national economic interests. This situation has put the United

States in a classic "Triffin" dilemma, whereby the use of the USD as a global reserve currency creates conflicts of interest between short-term monetary policy goals and long-term economic objectives. As the producer of the global currency, the US is forced to supply the world with abundant dollars and thus to accept a structural trade deficit. Conflicting monetary goals have also led to wide fluctuations in the US current account. In 2009, China's central bank governor Zhou Xiaochuan pinpointed these dilemmas (Zhou 2009).

The US exports dollars through trade deficits and forces its currency to depreciate against other currencies when trade deficits accumulate to certain level. Because of the depreciation, the US current account moves toward balance, and the US starts to export dollars through trade deficits again. **As a result, a peculiar periodic cycle is created:**

Trade deficits (imbalance) → depreciation (balance) → repeated deficits (repeated imbalance) → repeated depreciation (repeated balance) has been formed.

Each cycle is reflected by periodic imbalances.

Since the mid-1960s, the dollar has experienced three periodic cycles the details of which are as follows:

The first periodic cycle occurred between the mid-1960s and the late 1970's. At that time, the historic US trade surplus experienced a gradual decline. By 1971, the US current account balance to GDP ratio dropped below zero for the first time. The US exported dollars mainly through foreign investments to other countries and a large trade surpluses accumulated in Western Europe. In the 1970s, the Bretton Woods system collapsed amid the oil crisis. This led to substantial depreciation of the dollar and relieved the US current account deficit. The average

ratio of current account balance to GDP remained at zero with slight fluctuations.

The second periodic cycle occurred between the 1980s and the mid-1990s. The US current account balance dropped again to the level of -3%~-4% relative to GDP. Japan and some major European countries became the largest surplus countries. However, the "Plaza Accord" in 1985 pressed the dollar to depreciate sharply against the Yen, the German Mark, and a number of other currencies. In the early 1990s, the US current account was close to balance again.

The third periodic cycle started in the mid-1990s and has not yet ended. Following the Asian financial crisis, the US current balance to GDP ratio dropped all the way down: from -1.6% in 1997, to -3.2% in 1999, -4.5% in 2002. It reached -5.7% at the end of 2004. At that point, US current account deficits accounted for 75% of global current account surpluses and China has become the country with the largest trade surpluses in this cycle. In this most recent periodic cycle, the scale of trade imbalances has become larger than ever and has covered more regions and countries than in the past. These severe global economic imbalances, particularly the China-US economic imbalances, have resulted in global financial instability on a world-wide basis, especially in large emerging markets, and have sown the seeds of a future global financial and economic crisis.

The unique benefits of the international status of the USD for the United States

First, the United States has a unique "wealth-generating mechanism." Americans have become used to consuming and have found it difficult to save. The US household saving rate has remained around zero or has even been negative for some years, a situation that is connected to the rise in income and wealth inequality in the country since the early 1980s: the vast majority of middle-class Americans have faced tougher conditions and lost the ability to save (Rajan 2010; Stiglitz 2012).

However, US investors have received unprecedented returns and have been

able to rely on hidden and socialized risks through a financialization and debt-mutualization cycle:

Financing → purchasing financial assets (assets appreciation) → more financing → purchasing new financial assets (assets appreciation again)

Since the early 1990s, rising US stock prices and house prices have generated a "wealth effect" that boosted US consumption and economic growth. Large foreign purchases of USD assets and inflows into the US financial markets have participated in this large cycle of asset inflation. Since about 2000, China's large-scale integration into globalization has turned the country not only into a production base for the US manufacturing sector, but also into a massive de facto bank. The United States uses dollars to purchase cheap goods from China, and then China exchanges these US dollars for US Treasury bills. Naturally, China also benefits in this exchange, as the financing mechanisms has fueled large-scale production and exports from China, even though it places China in a dependent relationship. This process forms an excellent bilateral circulation of commodities and currencies.

Second, the current global monetary system confers other benefits to the US in the management of its external debt. The circulation of goods and currencies between China and the United States is well operated through the developed US financial system. A large amount of China's savings is transferred to United States through China's investment in Treasuries, part of which is used to support US purchases of products from China and part of which flows back to China in the form of FDI and hot money. By this means, the United States not only obtains low domestic inflation but also obtains high returns on investments in China. It is true, however, that the process is partially interactive and that China's long-held support for low wages and suppressed savings has played a role

in global imbalances and global flows.

In such a context, the US has been relying on structural twin deficits (budget and current account), both of which have risen dramatically in the 2000s. The large budget deficit has caused the overall US debt to increase from USD5.7 trillion in September 2000 to USD13.5 trillion in September 2010 and USD16 trillion in September 2012.[3] The share of external debt (treasury bonds held by foreigners) has also increased, but not at the same speed. The gross public debt of the US increased from USD1.32 trillion in June 2003 to USD5.0 trillion in March 2012.[4]

In the management of this large and rapidly rising foreign debt, the US has been able to rely on three advantages derived from the role of the US dollar as the sole reserve currency. One advantage is dollar depreciation. As a result of increased printing of dollars by the Fed, the value of the dollar has decreased relative to the other main currencies. This has the advantage of a de facto reduction in the US foreign debt.

Another advantage has been the increase in the value of the US foreign assets through high returns obtained on US investments abroad. For example, the United States borrows dollars from China through the issuance of treasure bills at little cost, and then invests the dollar in highly profitable sectors in China in the form of FDI, which rewards them with 10% returns. Admittedly, the US is not the only country that benefits from such FDI abroad (Japan, Korea, and the EU come to mind in particular), but the status of the USD makes it particularly useful.

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[3] Source: US Treasury (http://www.treasurydirect.gov/govt/reports/pd/histdebt/histdebt_histo5.htm; and US debt clock at http://www.usdebtclock.org/).

[4] Source: US Treasury: US gross external debt (long-term and short-term), http://www.treasury.gov/resource-center/data-chart-center/tic/Pages/external-debt.aspx

Six Major Dilemmas in the current International Monetary System

The first one is the New Triffin Dilemma. The concept of "new Triffin dilemma" was suggested by Robert. N. McCauley in 2003. By analyzing capital flows between the US and East Asian countries, McCauley argued that the US needs East Asian capital to sustain current account deficits through low-cost debt. In other words, East Asian countries become "sub-banks" of the US. However, the supply of dollars from these sub-banks depends on the US FDI in East Asian countries as well as the US current account deficits. Once the US current account deficits become unsustainable, the amount of the dollar flowing back to the US will shrink and in turn influence the US financial market.

Therefore, some may argue that international trade is essentially a game in which the US issues dollar bills, and the other countries produce commodities to exchange dollar bills and finally these bills flow back to the US. In other words, the stability of the existing international monetary system relies on stability of the US dollar, while the dollar stability depends on the US balance of international payments. However, as the supply of international liquidity depends on the US current account deficits, the US privilege of "seigniorage" will further expand the US current account deficits and affect balance of international payments as well as international status of the US dollar. That is the "New Triffin Dilemma."

The second dilemma can be called the N-1 problem. Any region composed of N countries with free capital flow and fixed exchange-rate regime will encounter "the N-1 problem." In such a regime, given N-1 countries holding fixed exchange rate policies, there will be one currency, which can artificially determine its internal and external values. This is called "the N-1 problem." There are three major solutions.

One solution is an asymmetric solution. The N^{th} country is assumed to implement its monetary policy independently, while other N-1 countries are responsible to maintain fixed exchange rate. The N^{th} country is thus the "core

country," while other N-1 countries are "periphery countries" as their monetary policies depend on that of the core country. As a result, they have to passively maintain fixed exchange rate and interest rate parity.

Another solution is a symmetric solution. The N countries share the responsibility of maintaining N-1 fixed exchange rates. In other words, the system needs to generate a single super-sovereign currency. There is no "core country" or "periphery countries." This solution can be achieved through members' joint coordination or through establishment of a common central bank that implements a unified monetary policy.

The last solution is to introduce the $N+1^{th}$ independent variable that is called an "external anchor" or "super-sovereign independent currency." By pegging their currencies to the external anchor, N countries experience fixed exchange rates with each other. Furthermore, the price of the "external anchor" is determined by external factors, while the N currencies are determined by internal factors, and thus producing a compatible system.

Overall, the first solution has been implemented in the current international monetary system, while the second and third solutions are still at the theoretical level.

Third is the problem of "conflicted virtue." The concept of "conflicted virtue" or "the effect of conflicted virtue" was suggested by Ronald McKinnon in 2005. McKinnon indicated that currency mismatch, or a dilemma of "conflicted virtue," will take place in any creditor country, which is unable to lend in its home currency (McKinnon 2005). East Asian countries with high saving rates tend to maintain current account surpluses that will lead to an increase of foreign claims. However, East Asian creditor countries are unable to lend in home currencies. Amid the rise of foreign claims, there will be two results. As the US dollar claims accumulate, dollar asset holders in East Asian countries increasingly worry that this trend will push home currency towards appreciation. Meanwhile, as some

East Asian countries continuously maintain trade surpluses, debtor countries will accuse them of artificially manipulating their currencies.

Consequently, there comes the problem of "conflicted virtue." The more complaints arise from trade-deficit countries, the more pressure will be imposed on home currency towards appreciation, and the stronger expectation on home currency appreciation results from domestic dollar asset holders. This process will then lead to a currency run through self-fulfilling mechanism. So long as there is currency run, the country will find itself in a dilemma under which is difficult to select appreciation or depreciation of its currency. If the currency appreciates, the economy will ultimately fall into a liquidity trap, bound towards deflation and a zero interest rate. If not, the country will suffer from trade sanctions by foreign countries and then incur enormous loss. However, for the creditor country with its home currency as an international currency, the problem of "conflicted virtue" does not exist. And this is the situation that countries find themselves in at the moment.

Fourth are various US Dollar traps. The first is the trap of economic development model. The "periphery countries" generally prefer dollar reserves and most of them have adopted an export-oriented strategy. This generates an economic development model with over-reliance on exports and insufficient domestic demand. The second is the trap of foreign exchange reserves. The "peripheral countries" with a great amount of dollar assets will fall into a dilemma whereby the increase in dollar reserves will lead to higher exchange rate risks, while the reduction in dollar reserves will cause dollar depreciation and result in the shrinkage of dollar assets. The third is the trap of investment loss. The 'periphery countries' mainly purchase US Treasury Bills with a yield normally hovering around 2%~4% (even lower now) as the major channel for investment of foreign exchange reserves. In addition, to attract FDI, these countries have paid expensive costs in finance, environment, and society. Moreover, although some of

these countries have higher saving rates, these savings cannot be converted into real investment due to inefficient investment channels.

The sovereign-debt crises in Greece and most of the Eurozone uncovered the tip of the iceberg of the global sovereign-debt crisis. Today, the greatest systemic financial risk in the world is that the US is heavily in debt. The US gross debt has reached nearly $16 trillion and the expenditure on the payments of debt interests, social security, health insurance and other welfare will account for 80% of overall federal income by 2020. Without the dollar's international status, the US government would have already likely experienced a sovereign debt crisis. It is the international status of the USD that has allowed the US to socialize its fiscal situation to the rest of the world.

Fifth is the contagion effect of the current financial crisis. This contagion effect means that dollar dominated international currency system exacerbates the accumulation and spread of financial risks. According to Stiglitz (2002), in the 25 years up to 2002, about 80 to 100 countries had experienced financial crises (Stiglitz 2002). The features of these crises are as follows: The financial crises in certain periphery economies are closely related to the US macroeconomic policies, such as the Mexican and Asian crises in the 1990s, and though their financial risks can spread between periphery countries, it will hardly affect the US. Meanwhile, the US also experiences financial crises due to its own domestic factors; these crises have easily spread around the world through channels of trade, finance and confidence, such as the 2008 global financial crisis. The financial markets of developing countries have often become the main speculative targets of international capital. It should be noticed that the USD always played the role of global 'safe harbor' and that the US was the major beneficiary of almost every financial crisis.

Sixth is the excess global liquidity. Under the dollar dominated international monetary system, US monetary policy leads to periodic depreciation

of the US dollar, global excess liquidity, and then global inflation. In recent years, the fundamental reason for the dramatic increase in oil and commodity prices is the excess of US dollars. Since the US dollar was cut loose from gold in 1973, the dollar exchange rate has been negatively correlated with the prices of commodities – gold and crude oil. In the years since the outbreak of the 2008 financial crisis, there has been a massive increase in the US monetary base that may well export the inflation of emerging countries in the coming few years.

THE POTENTIAL FOR THE G20 SUMMIT TO BRING REFORM TO THE INTERNATIONAL MONETARY SYSTEM

As noted above, the global monetary system embeds major imbalances and generates risks and volatility. As a result, there is a need for key countries to work together and identify a reform path that could usher in a more stable monetary system. The G20 is well-suited for this task. The G20 could then focus the historic mission of bringing reform to the international monetary system. Having a national currency – the dollar for instance – as the global reserve currency is not adapted to today's world economic development. With sharp fluctuations in exchange rates, it is difficult to monitor international capital flows, uncover financial risks ahead of time, and to secure the global system after a crisis occurs. If this system cannot to be reformed, it is likely that another financial crisis will occur.

Therefore, the G20 should set up a secretariat with the IMF to increase its transparency and accountability. Through in-depth communication, G20 should form a reform agenda of international monetary system to reach a consensus on guiding ideology, basic principles, reform objectives, basic steps, and main national responsibility.

In the following, we will present avenues toward a more stable IMS over the long-term. These avenues include a stronger role for the IMF, the development of Special Drawing Rights (SDRs) as a reserve currency, and a broad diversification of the current unipolar IMS toward a tripolar or quadripolar system (USD, Euro, RMB, and SDRs). Although these solutions are extremely hard to envisage in the short-term, they can form a basis for a long-term transformation of the monetary system.

1. Strengthening global cooperation and the coordination of economic policies

It is important to address sovereign debt problems in some established market countries and supervise the issuance of the world's main international reserve currencies. Diversification of international reserves should be the objective of international monetary system reforms. In such a diversified IMS, the dollar would continue to play an important role on a long term scale, while other currencies such as the Euro, Pound, Yen, and RMB, would play a growing role as additional international reserve currencies.

The key established market countries should gradually move to end their extremely low interest rate policies, given that such monetary policies have a detrimental impact on global capital flows and global imbalances. The US Federal Reserve and the European Central Bank should first raise their interest rates to bring real interest rates back to zero. At the same time, emerging economies should follow behind in increasing their interest rates moderately so as to curb the global spread of liquidity. Sequencing and gradualism may be essential in this process, given that growth remains fragile in key countries.

In order to maintain the stability of exchange rates between major economies, the IMF (or the FSB) should be authorized to supervise central banks in systemically important countries and thus manage the implementation of prudential exchange rate policies, set limits to the exchange rates fluctuation, and impose penalties on those violating these conditions. International financial

supervision in general should be strengthened, in particular the supervision of major international reserve currency issuers' monetary policies, and the supervision of cross-border capital flows should be consolidated. The G20 should pay particular attention to protecting weaker economies. To this end, the IMF should give updated instructions to large emerging market and developing economies regarding capital controls.

2. Reforming the Special Drawing Rights (SDRs) System

To accommodate the SDRs as an element of the new reserve currency system, the composition of the currency basket of SDRs needs adjustment. According to the IMF, the only criterion for inclusion in the SDRs is for the currency to be "freely usable". At the same time, the weight of a currency mainly depends on two factors: the scale of commodity and service exports of the economy and the quantity of the currency held by other economies as international reserves. In reality, the first criterion is no problem for an economy such as China. Moreover, in the recent year, RMB has been increasingly using in global trade. With RMB's internationalization, it could be expected that RMB become a part of the SDR currency basket in and around 2015. The IMF is currently working on expanding the scope of use of SDRs and to make the SDRs currency basket reflect more accurately the state of the world's economy. It is an important matter of credibility for the SDRs.

It is necessary to facilitate the transformation of the SDRs to an international reserve currency. The SDRs were designed to play a role in international clearing, commodity and asset pricing, as well as being a reserve asset. These purposes should not be abandoned. Currently, it is imperative to include large emerging economies' currencies in the SDRs' currency basket and reform the adjustment and distribution of the SDRs, because the current practice is too rigid, does not evolve with changing conditions, and can no longer satisfy the demand of the member states. Current practices also prevent the SDRs from playing a role in

international commodity and financial transaction activities commensurate with its design and intent.

Therefore, relevant IMF rules should be revised by authorizing the IMF to issue SDRs at its own discretion in accordance with the demand in the international financial market, allowing the IMF to purchase corresponding financial assets (such as government bonds of member states) with the SDRs, and allowing the member states to engage in international trade and investment activities with the SDRs borrowed from the IMF. Naturally, such issuance should follow strict guidelines. In essence, such reform is to grant the IMF the function to conduct open market operations as the world's central bank. In the long term, the extent to which the SDRs will strengthen the international monetary system depends on whether the IMF can play a bigger role. However, the IMF has been very slow in reforming the SDRs' distribution.

As a parallel reserve currency, the SDRs can balance and complement other reserve currencies, but it cannot conceivably fully replace them. In theory, the SDRs can serve as both a reserve asset and a transaction tool. A good way to start the reforms would be to encourage the use of the SDRs for a broader range of activities and to begin reducing the weight of the US dollar in the international reserve currency system. In the long run, SDRs should eventually be used in international transactions, in domestic currency transactions, and gradually become an international reserve currency. At all times through the reform of the SDRs, the principle of gradualism should be upheld to avoid too large a shock towards the international financial system. While continuously promoting the SDRs to act as an international reserve currency, the international community should also push the internationalization of the RMB to encourage a balance between the US dollar, the Euro, the RMB and other major currencies. This will to some extent reduce the "burden" of the US dollar in acting as the international reserve currency, and increase the stability of the international financial system.

3. Expanding the IMF's functions

The traditional function of the IMF is to advance international trade and promote healthy balance-of-payments. This is done through measures that are aimed at: avoiding the competitive devaluation of currencies and eliminating foreign exchange controls; providing financing; and acting as the global lender of last resort when balance-of-payments imbalances become an issue. The IMF should exercise its role fully and turn the SDRs into a new international reserve currency, but it should also supervise the economic behaviors of its member states. The IMF should: provide an early warning system; rescue economies in the advent of a financial crisis; prevent systematic risk; secure global financial stability; and in particular, supervise the issuance of major international reserve currencies and the cross-border flow of international capital.

In addition, the IMF should facilitate the mutual assessment process of the G20 and publish reports on spillover effects of the most systemically important economies. Finally, the IMF should be granted new responsibilities to supervise the stability of currencies, the global financial stability and even the capital account of the systemically important countries, while preventing states to falling prey to moral hazard. This can be done through the establishment of four mechanisms. The first is to build an international supervision mechanism for reserve currencies and let the IMF take on the responsibility of supervising international reserve currencies. When an international reserve currency is devalued, for instance, the IMF could create international pressure to impress upon the country to stabilize its currency.

The next mechanism is the establishment of a market competition mechanism of international reserve currencies. It could take a long time to build the SDRs into a "super-sovereign" international reserve currency, but building a diversified system under which several major currencies act as an international reserve currency is much more practical. If a reserve currency provides a stable

outlet, countries will hold onto it, and in turn create incentives that encourage the country to take currency stability measures, and prevent major international currency issuers from taking excessive monetary expansion measures.

An additional mechanism needed is to improve the international financial crisis bailout mechanism. In the previous financial crises, the IMF has provided emergency rescue. However, in most cases, the IMF has reacted slowly and in some cases even aggravated the situation. The IMF should increase its effectiveness in providing funding support for liquidity-deficient countries, perhaps even through the use of SDRs assets.

The final mechanism would be to improve collaboration and division of labor between the Bank for International Settlements (BIS) and the IMF. The BIS and the IMF coexist for historical and practical reasons, but the collaboration and balance between both organizations can be improved. Such collaboration could increase governance efficiency, decentralize risks and maintain global financial stability.

As mentioned above, there is a need to reform the governance of international institutions, including the IMF. In reality, the IMF could be compared to a joint-stock company. The reform of shares and voting rights would then be akin to the reform of the equity structure, the core of which is to rectify the fact that the US and the EU own the large majority of veto rights. In addition, a reform should also include a change in the election procedure for the senior leaders of the IMF, the seats on the executive board, as well as looking to increase the diversity of its employees. The distribution of the voting rights in the IMF should be commensurate with the economic strengths of its different member states, which means that, voting rights and management rights of developing countries should be enhanced within the IMF.

4. Reforming the World Bank's (WB) governance

The core function of WB is dedicated to economic development. The WB

should step up its loan support and technical assistance for developing countries, and contribute to global economic stability by strengthening its investments in the production and service areas and by encouraging international investments. It is necessary to enhance the role of the WB in stabilizing the international financial system, enlarge the functions of the WB Development Committee, and let the WB undertake part of the functions in supporting affected countries in reducing financial risks, and strengthen the funding assistance for countries impacted by financial crises in the regional level and global level.

5. Reforming the governance of Bank for International Settlements (BIS) and Enhancing the role of the Financial Stability Board (FSB)

The BIS has focused on providing monetary and financial transactions to the central banks of member states and helping them handle the conversion of official reserve currencies. The previous section has presented the case for increasing the weight of the SDRs in the trade, currency and financial clearing transactions of different countries, strengthening the role of the SDRs in the international economy and trade, and enlarging the position of the SDRs in the international clearing system. Depositing the SDRs at the BIS, instead of the IMF, would help decentralize risk. Establishing an international financial risk warning system centered on the BIS could increase the possibility of preventing international financial risks, provide underlying information for the IMF or other international financial institutions, and sound the alarm of financial risks for relevant member states. In addition, the functions of the Financial Stability Board need to be enhanced and work to establish uniform standards of international financial supervision.

6. Supporting emerging economies' participation in global economic governance

As a matter of fact, the US Federal Reserve has often expressed its concerns about the great global burden that befalls on its shoulders. Supporting the

increased participation of emerging countries in global economic governance is the best way to enhance their responsibility and reduce developed countries' burdens. For example, RMB internationalization will eventually reduce the burden carried by the USD. At present, the dollar dominated international monetary system is unstable. It is urgent to establish the "three pillars + the SDRs" for new international monetary system. Based on historical and present experiences, a unified currency system in East Asia is impossible to realize. Therefore, it is a general trend that RMB is becoming the international currency and one of the three pillars. The G20 should help China to form a competitive structure of "three pillars" including the US dollar, the Euro, and RMB. As part of this process, China would work over time to make the RMB fully convertible and make its financial markets deeper and up to international standards. The SDRs could serve as the global anchor in this decentralized tri-currency system.

7. Emphasizing the participation of member states' think-tanks

The G20 governance framework should include three levels: The first level is the G20 Summit as such, the second level is the G20 conference of finance ministers and central bank governors, and the third level should be a network of think tanks of different member states under the coordination of the IMF. Such network could provide informed support for the G20 and provide a platform for the exchange of ideas and expertise on the reform of the international monetary system. If this network is representative across developed and emerging economies, it could play a key role in providing credible score cards, evaluations, and new ideas for governments to consider within the G20.

Experience suggests that think tanks may play a unique role in global economic governance. At present, the global economy is facing some complex challenges that need think tanks to provide theoretical and quantitative analysis and solutions. National think tanks can submit new ideas that emerge within countries and express their independent views on major international issues.

Global governance should enhance inclusive development, rather than support of national government policies. Yet, think tanks can be key links and catalysts in the promotion of a track-two-dialogue. They can bridge gaps between countries and between the world of ideas and the world of policy. Think tanks should play an independent, scientific, pragmatic, and critical role. In this way, G20 members could designate their chosen leading think tanks to organize and coordinate studies of the reform of the international monetary system and facilitate relevant academic exchanges between member states. Coordinating think tanks in various countries could be a catalyst for the integration of professional talents and resources from various countries, and thus promote constructive studies and exchanges relating to the reform of the international monetary system.

THE POLITICAL ECONOMY OF IMF REFORMS: FEASIBILITY AND SCENARIOS

The above discussion is a purely theoretical discussion about a possible arrangement of global institutions that would serve the global public good of financial stability and fulfill the needs of the world economy. Naturally, it requires both a thorough discussion of costs, benefits, opportunities, and risks. It also requires a pathway on how to get from the current system to the potentially superior system described above. This takes us into the realm of political economy. Inevitably, movement away from the US dollar as the global currency would face opposition from the incumbent that will lead to three potential scenarios.

Scenario 1 would envisage a grand bargain among the powers of the G20 and a negotiated transition from the current US-based unipolar system to a globally supervised tripolar or quadripolar system. Such a bargain would offer the opportunity of balancing a pareto-optimal outcome with concessions to the withdrawing hegemon. Although it is the optimal path, it may not be very likely

given the level of mobilization by vested interests and given the complexity of designing such a transition.

Scenario 2 could envisage a decentralized self-enforced transition as a fallback. Competitors to the US would gradually sponsor the international use of their currency and the system would naturally evolve. This is what the EU tried to do with the Euro and what China is seeking to quietly do with the renminbi. The problem with this option lies in the risk of unsettled political implications and potential tensions among great powers. Currency lies at the heart of sovereignty — currency is power. A messy decentralization can lead to a currency war and to plots to undermine rivals. There is risk in entrusting to market mechanism what is fundamentally a political issue.

Scenario 3 might envisage a catastrophic collapse of the current USD dominated system and a post-crisis coming together of a new system. Historically, currency regimes have known transitions through such collapses. A massive crisis carries great risks and is not optimal in terms of public good. The likelihood of such a catastrophic scenario could enhance the willingness of great powers to consider scenario 1.

In sum, the negotiations around the currently instable international monetary system are a matter of paramount importance for the future of the global economy (Strange 1998). It is an arena where raw interests clash and these interests must be addressed in order to avoid a mutually destructive scenario (Carr 1939). The G20 is currently the one institution and forum with the best potential for great powers to come together and negotiate a great transition to a new more stable IMS. It is a long-term task with no obvious solution, although this paper has sought to raise a few sensible suggestions.

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