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Asia's Role in the Global Economic Architecture

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Abstract: The global economic and financial landscape has been transformed over the past decade by the growing economic size and financial power of emerging economies. The new G20 summit process, which includes the largest emerging economies, has established high-level international policy cooperation in this new setting. This paper argues that effective global economic governance will also require changes in key global organizations—such as the International Monetary Fund, World Bank, World Trade Organization, and the Financial Stability Board—and closer collaboration between global and regional organizations. We suggest that federalism be introduced on a global scale by creating hierarchies of global and regional organizations with overlapping ownership structures in various functional areas (as is already the case with the World Bank and regional development banks in the area of development finance). Asia could contribute to this transformation by building effective institutions to promote macroeconomic and financial stability and deepen regional trade and investment integration.

JEL Classification: F02, F13, F33, F55, O59

Contents

1. INTRODUCTION

The global financial crisis confirmed the growing interdependence of the world economy and the need to coordinate economic policy on a global scale. As they scrambled to respond to the crisis, heads of major economies upgraded the Group of Twenty (G20) finance ministers meeting into a leaders' process that would act as the "steering committee of the world economy." [1] The 2009 London Summit placed special emphasis on building or rebuilding international institutions by increasing the financial capacity of the International Monetary Fund (IMF), establishing a new Financial Stability Board (FSB), and committing to reforms in the management, staffing and voting shares of major international organizations. [2] Following a general capital increase of the Asian Development Bank (ADB), the Pittsburgh Summit suggested similar capital increases in other multilateral development banks.

The world's international economic organizations—essentially designed in 1944—now face the challenge of managing the global economy in an unusually demanding and radically different environment. The influence of the IMF, in particular, had declined in the long prosperous era before the crisis, and by 2007 its lending had fallen to near zero. One-quarter of its staff had taken early retirement and plans were in place to sell gold reserves to sustain operations. In addition, considerable distance had emerged on the role of the IMF between the IMF itself and policymakers in important parts of the world. Voting reforms had not kept pace with changes in world production, and the much-criticized role of the IMF in the 1997–1998 Asian financial crisis had made it a "third rail" in the politics of many developing economies. [3]

A central feature of the new global economic and financial landscape is the rise of emerging economies, particularly People's Republic of China (PRC) and India. In addition to their large populations, their economic size and financial power—measured by output, trade volume and foreign exchange reserves—have grown very rapidly. These economies are also playing an unexpectedly large role in the recovery from the global financial crisis, having continued to grow at rapid rates even during the global recession. A new design of global economic architecture—led by the G20 summit and supported by key international organizations—would require greater commitments and responsibilities from these emerging players. In turn, this would call for fundamental reform of their governance.

In this paper we explore reforms in the governance of the global economy, with particular attention to the potential role of regional institutions. We examine the challenges of key international organizations using an analytical perspective—based on the theory of clubs—that highlights the objectives and constraints embedded in their structure. We argue that the reforms currently discussed (principally in voting shares), while important, are not sufficient. The structure of existing organizations is inherently inflexible, and innovations focusing on regional organizations would be required to make the system responsive to the needs of a rapidly changing world economy.

The paper is organized as follows. Section 2 discusses the recent and prospective rise of new players in the global economy, particularly the PRC and India, and suggests that the voice and responsibilities of these economies in global economic management will have to be substantially upgraded. Section 3 examines the pressures for reform in key global economic organizations. Section 4 considers the challenges to reform from the perspective of club theory. Section 5 suggests possible solutions, including "federalizing" global economic governance by developing "families" of closely linked regional and global organizations. We

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[1] Eichengreen (2009).

[2] For example Truman (2008), IMF (2008a, 2008b), Bryant (2008), Cooper and Truman (2007), and Dervis and Ozer (2005). A wider range of studies on structural issues and reform is collected in Truman (2006).

[3] Thus, when the current crisis began, Korea and Singapore turned to *ad hoc* bilateral currency swaps with the US Federal Reserve System instead of loans from the IMF.

believe that such a system would provide building blocks for a stronger global architecture where major emerging economies can play more active roles. Section 6 concludes the paper.

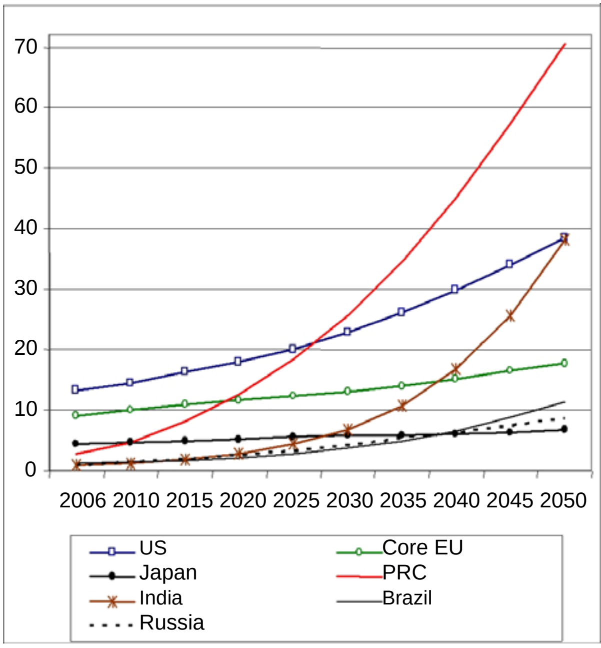
2. CHANGING ECONOMIC LANDSCAPE: THE RISE OF ASIA

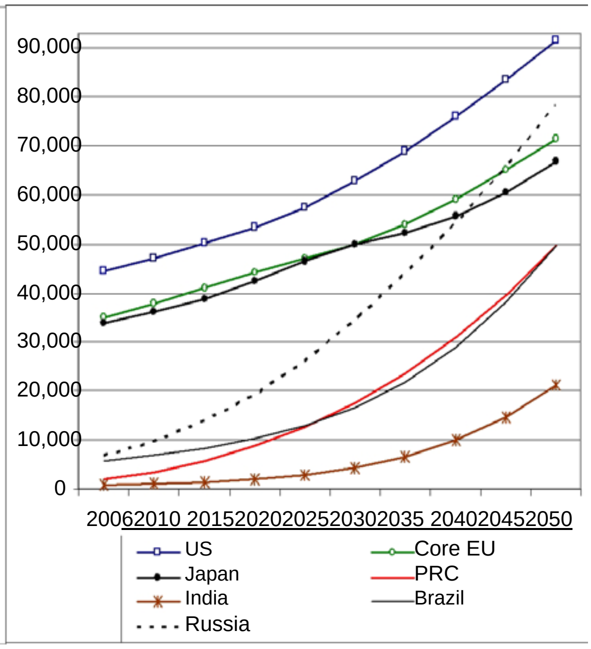
The rise of emerging economies—especially the giant Asian economies—are rapidly changing the structure of world trade and finance. The management of global economic and financial affairs—adopting policies to sustain economic growth and promote stable finance—is becoming increasingly difficult without their active participation.

Growing economic weight

According to projections made by Goldman Sachs (2007), the emerging economies will grow rapidly over the next 40 years. Figure 1a shows that PRC's gross domestic product (GDP) (in 2006 prices) will grow quickly, surpassing Japan's in 2010 and the United States (US) GDP in the second half of the 2020s, thereby rising to become the world's largest economy by 2030. Similarly, India will also grow quickly by taking advantage of its favorable demographics, and its GDP is projected to overtake Japan's before 2030, and may catch up with the US's in around 2050. Brazil and Russia may not be as powerful economies as PRC and India, but their GDPs may overtake Japan's by 2040. (However, Figure 1b demonstrates that there will remain large gaps between the advanced economies and emerging economies—except for Russia—in terms of per capita incomes.)

Figure 1: GDP Projections for the US, Japan, Europe, PRC, India, Brazil, and Russia 1a. GDP (at 2006 US$, Trillion) 1b. Per Capita GDP (at 2006 US$)





Note: Core EU means European Union and refers to France, Germany, Italy and the United Kingdom.

Source: Goldman Sachs (2007).

These projections are of course uncertain, and could prove too optimistic if the world fails to address emerging constraints on the environment and on food, water, and resource availability. Nonetheless, they provide some useful guidance on the likely shift in economic power away from the traditional, advanced economies towards newly emerging players such as the PRC and India.

Foreign exchange reserves

Major emerging economies have relied on international trade and investment for their economic development and have clearly and substantially benefited from globalization. Some have experienced large current account surpluses and/or rising capital inflows and thus accumulated sizable foreign exchange reserves. This is particularly the case with the PRC, some other Asia's emerging economies, and oil producing countries such as Saudi Arabia and Russia. The ongoing global financial and economic crisis demonstrates once again that holding large foreign exchange reserves can provide countries with space for macroeconomic policy and cushion them in weathering financial turmoil.

Countries with large foreign exchange reserves have also made contributions to global financial stability by providing part of their reserves to the IMF, or making them available for other purposes. The G20 leaders agreed at the London Summit to expand the size of IMF resources from the then existing US$250 billion to US$750 billion in order to cope with the negative impact of the global financial crisis on emerging economies. Part of this financing came from advanced economies—US$100 billion each from Japan and the US and almost US$180 billion from European Union (EU) countries—but part came from emerging economies with abundant foreign exchange reserves; PRC led the way by providing up to US$50 billion, followed by Brazil, India, Republic of Korea (hereafter Korea) and Russia each providing US$10 billion. [4]

Global demand and economic recovery

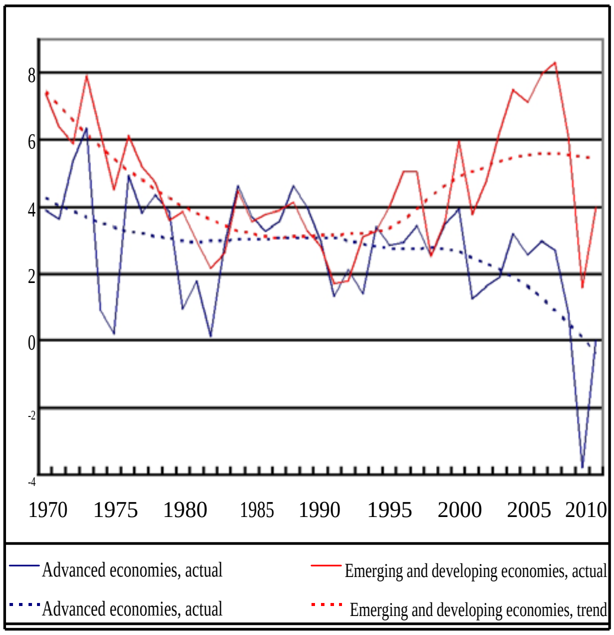
PRC, India and other emerging economies have figured prominently in the recovery from the global financial crisis. Figure 2a plots annual real economic growth rates for advanced economies and emerging and developing economies (solid lines), along with their respective trend growth rates (dotted lines). Trend growth for emerging and developing economies was higher than that for advanced economies in the 1970s but the gap narrowed over time and essentially disappeared between 1985 and 1995. Since the second half of the 1990s, trend growth of emerging and developing economies has been rising, while that of advanced economies has been declining. There is clear "trend decoupling" between these groups over the past 10 years (although Figure 2b shows evidence against "cyclical decoupling") and most projections expect that trend to continue.

Thus, major emerging economies have made surprisingly important contributions to the global recovery. Some of the largest have grown throughout the global financial crisis and helped to mitigate the collapse in global demand. They have pursued expansionary macroeconomic policies and are now embarking on structural policies to shift their economies' dependence from extra-regional to Asian demand. These policies are expected to also help to unwind global payments imbalances.

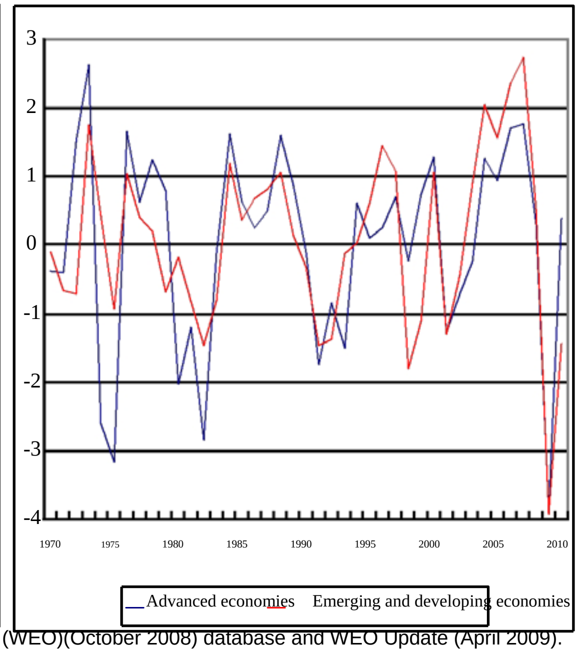
[4] See IMF, "Bolstering the IMF's Lending Capacity" (last updated 28 May 2010). http://www.imf.org/external/np/exr/faq/contribution.htm

Figure 2. Growth Rates of Advanced and Emerging & Developing Economies

2a. Trend Decoupling



2b. Cyclical Coupling



Source: Computed from IMF, World Economic Outlook (WEO)(October 2008) database and WEO Update (April 2009).

3. OBJECTIVES OF GOVERNANCE REFORM

Despite their rising influence and responsibilities, the voice of emerging economies remains weak in global governance. Their voting shares have been disproportionately low in the IMF and the World Bank. No large emerging economy was represented in the Bank for International Settlements (BIS) family, including the Financial Stability Forum (FSF). No emerging economy was a member of the G7 process, and only Russia became a formal member (of the G8) at the Birmingham Summit in May 1998.

The relatively low voting power of emerging economies in the IMF and World Bank has been long recognized. Consider, for example, the voting shares of the PRC (the sixth largest share, with 3.7%), India (thirteenth, 1.9%), Mexico (sixteenth, 1.45%), Brazil (eighteenth, 1.4%), and Korea (nineteenth, 1.35%). These compare with those of the Netherlands (eleventh, 2.4%), Belgium (twelfth, 2.1%), and Switzerland (fourteenth, 1.6%), economies that are far smaller in size (see Table 1, where the top 30 economies in the world are listed according to economic size measured by GDP at purchasing power parity [PPP]). In effect, voting rights in these organizations to a large extent still reflect decisions made at Bretton Woods in 1944.

Against this background, the G20 summit process represents an important shift. It includes large emerging economies in global decision-making and thus also sets the stage for other reforms. But establishing the G20 is not enough; even if this process provides high level leadership, it will need effective complementary institutions to implement its vision. This makes reform of the global economic architecture a high priority. In this section, we examine the progress of the G20 and the four institutions in the global governance system that will be essential for implementing G20 decisions: the IMF, the multilateral development banks (MDBs), the World Trade Organization (WTO) and the FSB.

Table 1: Ranking and Shares of IMF/World Bank Voting Powers and Economic Weights of Top 30 Economies in the World, 2009

	IMF Quota & VP				World Bank VP				GDP				Trade		FXRs		Population	
	Quota		VP		IBRD		IDA		Current		PPP							
US	1	17.09	1	16.77	1	16.36	1	12.16	1	24.61	1	20.42	1	10.68	23	0.62	3	4.56
PRC	6	3.72	6	3.66	6	2.78	13	1.88	3	8.47	2	12.56	2	8.85	1	29.44	1	19.82
Japan	2	6.12	2	6.02	2	7.85	2	9.53	2	8.75	3	5.96	4	4.54	2	12.23	10	1.89
India	13	1.91	13	1.89	7	2.78	7	3.13	11	2.13	4	5.05	17	1.64	7	3.17	2	17.81
Germany	3	5.98	3	5.88	3	4.48	3	6.30	4	5.79	5	4.02	3	8.29	34	0.45	15	1.22
UK	4	4.94	4	4.86	4	4.3	4	5.37	6	3.77	6	3.06	6	3.37	32	0.47	22	0.92
Russia	10	2.74	10	2.69	7	2.78	50	0.31	12	2.12	7	3.02	14	2.06	3	4.98	9	2.10
France	4	4.94	4	4.86	4	4.3	5	4.04	5	4.62	8	3.02	5	4.13	42	0.34	21	0.93
Brazil	18	1.40	18	1.38	13	2.07	14	1.60	8	2.72	9	2.88	24	1.15	9	2.85	5	2.84
Italy	7	3.25	7	3.19	7	2.78	9	2.57	7	3.66	10	2.49	8	3.27	36	0.42	24	0.89
Mexico	16	1.45	16	1.43	20	1.18	24	0.74	14	1.51	11	2.10	16	0.92	14	1.15	11	1.60
Korea	19	1.35	19	1.33	22	0.99	27	0.68	15	1.44	12	1.95	10	2.75	6	3.25	26	0.72
Spain	17	1.40	17	1.39	15	1.74	21	0.89	9	2.53	13	1.95	15	2.05	58	0.16	27	0.68
Canada	9	2.93	9	2.89	7	2.78	8	2.69	10	2.31	14	1.84	11	1.32	27	0.52	36	0.50
Indonesia	23	0.96	23	0.95	23	0.94	22	0.87	18	0.93	15	1.38	30	0.85	20	0.74	4	3.44
Turkey	36	0.55	36	0.55	36	0.53	28	0.63	17	1.06	16	1.26	29	0.97	19	0.85	18	1.05
Australia	15	1.49	15	1.47	17	1.52	15	1.23	13	1.72	17	1.22	20	1.28	37	0.40	49	0.32
Iran	29	0.69	29	0.69	18	1.48	141	0.08	29	0.57	18	1.19	36	0.54	171	0.00	17	1.10
Taipei,China	--	--	--	--	--	--	--	--	25	0.65	19	1.05	18	1.52	5	4.27	47	0.34
Poland	33	0.63	33	0.63	30	0.69	10	2.10	21	0.74	20	0.99	26	1.12	17	0.90	33	0.57
Netherlands	11	2.37	11	2.34	12	2.21	11	2.02	16	1.37	21	0.94	7	3.28	64	0.11	59	0.24
Saudi Arabia	8	3.21	8	3.16	7	2.78	6	3.30	26	0.64	22	0.85	19	1.34	4	4.87	45	0.38
Argentina	22	0.97	22	0.97	21	1.12	25	0.73	30	0.54	23	0.84	42	0.38	26	0.53	31	0.60
Thailand	39	0.50	39	0.50	45	0.41	38	0.39	33	0.46	24	0.77	23	1.15	12	1.64	19	0.99
South Africa	25	0.86	25	0.85	25	0.85	54	0.30	32	0.50	25	0.72	35	0.54	38	0.40	25	0.73
Egypt	43	0.43	43	0.44	41	0.45	33	0.49	43	0.32	26	0.67	55	0.27	40	0.38	16	1.14
Pakistan	41	0.48	41	0.48	33	0.59	20	0.92	46	0.29	27	0.62	61	0.19	62	0.12	7	2.43
Colombia	58	0.36	53	0.36	44	0.41	32	0.50	36	0.40	28	0.58	56	0.26	45	0.28	29	0.67
Belgium	12	2.12	12	2.09	14	1.8	17	1.13	20	0.81	29	0.55	9	1.49	67	0.10	72	0.16
Malaysia	30	0.68	30	0.68	37	0.52	37	0.40	42	0.33	30	0.55	25	0.88	15	1.14	44	0.41
EU		32.39		31.85		28.54		32.40		28.39		21.19		35.71		6.39		7.39
G20		79.14		77.87		75.85		72.18		87.84		83.24		75.00		74.00		65.76
East Asia		14.57		14.43		14.44		14.85		22.23		26.02		26.43		58.85		31.67

Note: VP= voting powers; GDP (current) = at current prices in the US dollar; GDP (PPP) = at PPP international dollar; FXRs = foreign exchange reserves. EU= European Union. UK= United Kingdom, US= United States.

Source: IMF, *World Economic Outlook*, April 2010 database; IMF, *International Financial Statistics*, CD-ROM; IMF and World Bank, website.

Emergence of the G20 summit

The establishment of the G20 summit process in November 2008 and its subsequent designation as the "premier forum" for international economic and financial policy cooperation in Pittsburgh in September 2009 fill a major gap in global economic governance. The G20 includes both advanced and emerging economies [5] and should benefit from much greater legitimacy and effectiveness in tackling global issues than its G8 predecessor. G20 participants account for 83% of global GDP (in PPP), 75% of global trade and 66% of global population.

The first meetings of the G20 summit addressed an ambitious list of actions and institutional reforms, calling for (i) implementing concerted monetary and fiscal policies to support global aggregate demand in the early stage of the recovery from crisis, (ii) achieving balance between growth and the sustainability of public debt in the later stages of the recovery; (iii) restoring the health and soundness of US and European financial systems; (iv) providing further international liquidity and funding for affected developing and emerging economies through financially enhanced international financial institutions (i.e., the IMF and MDBs); (v) preventing trade protectionism and concluding the Doha Development Round; and (vi) reforming global financial governance by expanding the Basel Committee on Banking Supervision [6] and converting the former FSF into a larger FSB. [7]

But the G20 summit is merely a first step. Though policymakers in each economy can take actions on national agendas—macroeconomic stimulus, debt sustainability, national financial system health, and trade regime openness—and can collectively decide on global agendas, they have no capacity to carry them out. Many of the needed global policy measures would have to be implemented by the relevant international organizations. Thus, an effective global governance system would require additional reforms in existing and new institutions such as the IMF, the World Bank, the WTO, the FSB and other international and regional organizations, as well as an effective division of labor among them.

Macroeconomic stability and the IMF

The IMF is the principal international organization charged with safeguarding global macroeconomic and financial stability. To achieve this, the IMF mainly relies on two instruments: surveillance and crisis lending. The IMF's surveillance mission includes conducting regular macroeconomic consultations with its member economies and now also supporting the G20's "Mutual Assessment Process" of national macroeconomic recovery strategies. But the IMF's ability to identify and mitigate macroeconomic and financial risks remains in doubt. The IMF has been unable to anticipate various past crises, or to propose effective remedies for overcoming them. Notably, the IMF did not foresee or take actions to contain the risks that built up in the US, the United Kingdom (UK), and other European countries in the period leading up to the global financial crisis.

The IMF's lending capacity is potentially a key instrument for managing and containing economic crises. However, the IMF has been criticized for applying inappropriate—and extensive structural—conditionality to its loans in crisis environments, especially during the Asian financial crisis of 1997-98. Responding to such criticisms, the IMF has streamlined

[5] The G20 Finance Ministers and Central Bank Governors was established in December 1999 to bring together systemically important industrialized and developing economies. In November 2008, leaders of the G20 countries met for the first time in Washington, DC to initiate the G20 summit process. The members of the G20 are: Argentina, Australia, Brazil, Canada, PRC, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States and the European Union.

[6] The members of the Basel Committee are: Australia, Belgium, Brazil, Canada, China, France, Germany, India, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Spain, Sweden, Switzerland, the United Kingdom and the United States.

[7] The members of the FSB are: Argentina; Australia; Canada, China, Brazil, France, Germany, Hong Kong, China; India, Indonesia, Italy, Japan, Korea, Mexico, Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Switzerland, Turkey, the United Kingdom, the United States, and the European Union.

conditionality by focusing on clearly macroeconomic-related policy measures, and formulated several new credit facilities designed to be more flexible and less dependent on ex-post conditionality. [8] The IMF's new lending programs have not been tested in Asia during the global financial crisis so far, but there remains much political opposition in the region to relying on the IMF. Nonetheless, the expansion of IMF resources clearly adds urgency to the need to improve its effectiveness and credibility.

An essential reform is to change the IMF's voting structure and management. As Table 1 indicates, emerging economies are under-represented, while Europe is over-represented in IMF quotas and voting powers. Although the US also appears to be under- represented, it is the only country among the 186 members with a quota above 15%, and under the IMF's charter that gives it veto power over major decisions. In addition, the managing director of the IMF has been restricted, by convention, to European nationals in the past.

In general, the international macroeconomic architecture suffers from serious governance problems. The IMF's inadequate responses in the Asian financial crisis may have been due to the lack of Asian representation in its management. In the wake of the global financial crisis, another set of problems is emerging; given significant macroeconomic spillovers, policymakers in one country may believe that they can avoid taking difficult policy steps while waiting for others to do so. The international system has few tools to manage such conflicts of interest and to encourage cooperation. As is well known, this kind of "game" leads to inadequate cooperation, free riding, moral hazard, and suboptimal outcomes. An alternative, improved system might provide ways for countries to manage cooperation in smaller regional groups if their economies are closely linked.

Development finance and the MDBs

The multilateral development banks—the World Bank [9] and regional development banks—aim to help developing countries achieve sustainable economic development and poverty reduction. They typically perform three related functions: lending, providing knowledge, and delivering public goods.

The World Bank provides market -based and concessionary loans for development-oriented investments. Capital-scarce poor countries have few alternatives to this kind of financing, and even some middle-income developing countries benefit from it due to their limited access to international capital markets. World Bank loans are guided by Country Assistance Strategies that identify key development challenges, especially with regard to poverty. [10] As knowledge banks, MDBs provide economic analyses, policy advice, and technical assistance. Finally, the MDBs also generate international public goods, such as fighting communicable diseases, protecting the environment, mitigating the impacts of natural disasters, and containing conflict.

The World Bank's governance parallels that of the IMF. Its work is augmented by four regional development banks: the African Development Bank (AfDB), the Asian Development Bank (ADB), the European Bank for Reconstruction and Development (EBRD), and the Inter-American Development Bank (IDB). These are further complemented by smaller sub-regional banks.

While the MDBs are not as much in the center of the storm as the IMF, their operations have been criticized for being guided more by public opinion in developed countries than by the development needs in poor economies. In a thorough study of the World Bank in the US, the

[8] An overview of the IMF's current (and rapidly changing) lending facilities is provided by the "Factsheet: IMF Lending" which can be found online at:
http://www.imf.org/external/np/exr/facts/howlend.htm.

[9] The World Bank Group comprises the International Bank for Reconstruction and Development (IBRD), the International Development Association (IDA), the International Finance Corporation (IFC), and the Multilateral Investment Guarantee Agency (MIGA).

[10] To streamline the poverty reduction work, the World Bank may consider taking over the IMF's Poverty Reduction and Growth Facility (PRGF) and integrating it with its own Poverty Reduction Support Credit (PRSC).

Meltzer Commission (Meltzer 2000) envisioned an especially large role for the regional development banks—eventually handling all lending while the World Bank focused on its knowledge and public goods functions—but noted that current activities often overlap. The G20 has agreed on larger general capital increases for the regional development banks than for the World Bank, [11] perhaps signaling a longer-term increase in their relative role in global development finance.

Trade liberalization and the WTO

The WTO and its predecessor, the General Agreement on Tariffs and Trade (GATT), have promoted liberal, non-discriminatory and multilateral trade and have contributed substantially to growth in advanced as well as emerging and developing economies. But as the scope of trade liberalization has expanded from tariffs on manufactured products to non-tariff measures, agricultural products, and services, global trade liberalization has become more complex. In addition, the WTO has brought emerging economies directly into the negotiations, and has revealed key points of difference between developed and emerging economies on the future directions of liberalization. So, after eight successful trade rounds, the global negotiating framework is at an impasse, and the current Doha Development Agenda enters its tenth year of negotiations with little sign of breaking the deadlock.

Meanwhile, bilateral and plurilateral free trade agreements (FTAs) have proliferated. Although FTAs must theoretically comply with provisions set by GATT Article XXIV, [12] most have been made outside the WTO's purview. There are now major trade agreements in Europe, North America, Latin America, the Gulf countries, and Asia. Many Asian countries participate in a "hub and spoke" network centered on Association of Southeast Asian Nations (ASEAN), with overlapping FTAs. The WTO has been silent on the proliferation of FTAs, but could play a more proactive role. Baldwin (2006) argued that there are benefits from consolidating regional agreements into a coherent global system, and this is an area where the WTO could make major contributions.

Unlike the IMF and the World Bank, the WTO is member-driven and consensus-based. It has a small Secretariat, much of which supports administering existing obligations, including especially the Dispute Settlement Body. Most of the WTO's work is done in councils and committees by its member governments. Thus, the WTO is inclusive and representative, but its major weakness is in effectiveness; the unwieldy negotiating framework and the requirement for consensus make it difficult to achieve breakthroughs that might be acceptable to its membership.

Financial stability and the FSB

An important factor that led to the global financial crisis was the lack of an international financial regulatory/supervisory framework that is capable of regulating, monitoring, and supervising the cross-border activities of systemically important financial institutions and internationally connected financial markets. Ideally, a new global financial regulatory and supervisory body should be created—with the participation of key emerging economies—to internationally harmonize supervision, regulation and resolution. To this end, the G20 agreed to strengthen the BIS Basel Committee and to upgrade the FSF into a more powerful FSB. The FSB is mandated to collaborate with the IMF to provide early warning of macroeconomic and financial risks and to take actions to address them.

This move has been supported by the US efforts to upgrade its financial regulatory and supervisory structures. [13] Major emerging economies' participation in global financial

[11] The following general capital increases have been made: AfDB 200%; ADB 200%; IDB 70%; EBRD 50%; and IBRD of the World Bank Group 30% and IFC US$200 million.

[12] One of the functions of the WTO is to monitor the world trading system—including trade policy reviews to monitor compliance with WTO obligations.

[13] The US has highly fragmented supervisory systems for commercial banks, a very weak supervisory framework over investment banks and security houses, and state-by-state regulation over insurance companies.

supervision is also a welcome development as this allows their views to be reflected in, and their practices to be overseen by, the FSB. But the hard work still lies ahead: the resources and human capacity of the FSB are limited relative to its expanded mandate, and since the reform of the regulatory system is largely national in scope, much depends on the willingness of countries to cooperate through the FSB.

4. CONSTRAINTS ON GOVERNANCE REFORM: IMPLICATIONS OF CLUB THEORY

Global organizations face significant challenges in supporting the G20 process and, more broadly, in delivering effective economic and financial governance. This section attempts to analyze these challenges from a deeper analytical perspective—based on the theory of clubs—that highlights the logic of international economic governance. [14]

International organizations as clubs

In the language of economic theory, international organizations are clubs—institutions that produce goods that are at least partially non-rivalrous (more than one user can consume their services) and at least partially excludable (users can be denied access to them). The services offered by international organizations—macroeconomic and financial stability, poverty reduction of developing economies, and rules governing global commerce—are critical public goods. Once produced, they are available to any country without significantly diminishing their value to others. The theory of clubs is an important tool for understanding international organizations as well (Fratianni and Pattison 1982 and 2001, and Lawrence 2008). [15]

International organizations, as other clubs, provide services that are essential, and under some conditions optimal, and yet cannot be produced privately. They are also subject to the challenges faced by clubs. They are not easily "scaled"; expanding clubs become unwieldy because larger memberships make it harder for them to meet the preferences of all club members. They are also inflexible; charters and super-majority voting rules, designed to insure the interests of a club's charter members, place strict limits on change.

These problems are not apparent when clubs are formed: founding members have common interests and create services to meet common needs, as did the original participants at the Bretton Woods conference. But over time, as a club's membership grows, the interests of members diverge. This creates internal tensions and, eventually, makes clubs unable to meet all members' needs. These problems are compounded by charters that make change difficult.

Implications for necessary reforms

The evolution of the IMF, the World Bank and the WTO roughly confirm the predictions of club theory. As Figure 3 shows, their memberships have multiplied since they were originally founded. Yet governance structures and voting shares have adjusted little. Quotas have been revised several times since they were first set in 1944, but have not kept pace with economic change. [16] As already noted, emerging economies have much smaller voting shares than countries that were among initial or early members. As a result of these issues, international organizations have found it increasingly difficult to carry out their responsibilities.

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14 These issues are worked out in greater detail in Kawai, Petri and Sisli-Ciamarra (2010).

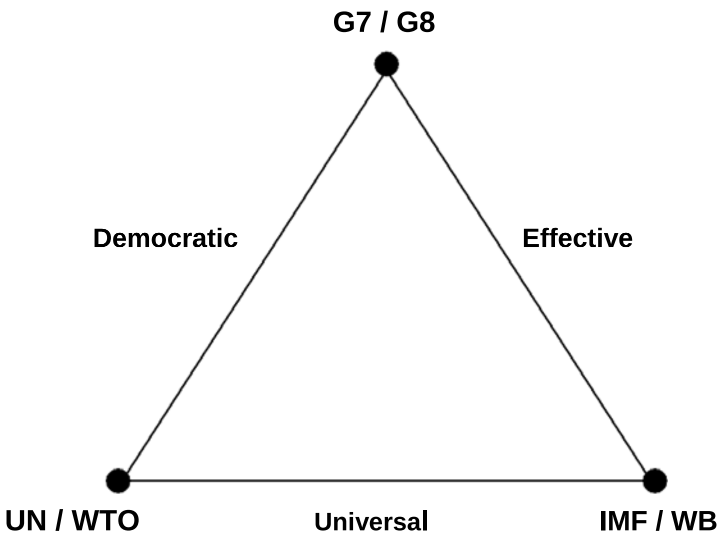
15 See Sandler and Tschirhart (1980) for a comprehensive survey. Seminal contributions were made by Buchanan (1965) and Olson (1965).

16 The IMF's Board of Governors conducts general quota reviews every five years. Any proposed changes in quotas must be approved by an 85% majority.

Specifically, international organizations have encountered three kinds of problems. First, since they have been unable to agree on significant expansions of financial resources, they have become "small" relative to governments and financial markets. The G20 has now stepped in to relieve the funding constraints of the IMF and the MDBs. Second, since international organizations serve many more members, they have undertaken to produce many new services—a process that Lawrence (2008) described as "mission creep"—but do not have the resources or mechanisms to engage in them more than superficially. For example, developing economies want to see a greater focus on development, technology transfer, and international investment, while advanced economies want more attention focused on the environment, labor and human rights. Third, given their growing memberships and wider mission, they have grown distant from certain members, and hence the effectiveness of their operations—e.g. in the Asian financial crisis—has come under wide criticism.

These challenges reflect structural problems. Ideally, international organizations should be universal (globally inclusive) and democratic (responsive to individual members), but they also have to be effective (able to adapt and deliver services quickly). But all three of these goals are very difficult to realize together—yielding a type of "governance trilemma." Organizations can satisfy two of the three goals, but new structures will be needed to satisfy all three. For example, as Figure 4 suggests, the United Nations (UN) or WTO is a universal and democratic organization, but has difficulty making and implementing decisions. Smaller institutions and forums, such as the G7 or G8, are democratic and agile, but not inclusive. And the "old" IMF was universal and could act quickly—but at the cost of democratic governance.

Figure 4: The Governance Trilemma



Source: Authors.

5. REGIONAL GOVERNANCE AS A BUILDING BLOCK FOR GLOBAL GOVERNANCE

The governance trilemma suggests the need for institutional innovations. One promising solution is to replace monolithic international organizations with a multi-layered decision-making structure, along the lines of "functional federalism" advocated on a national level and in Europe (Casella and Frey, 1992) or the "principle of subsidiarity" [17] in European governance. This would enable universal institutions to become more effective by delegating decisions internally to subgroups with fewer, and ideally more likeminded, members.

Institutional families and decentralization

Decentralization could be achieved within a global organization by enabling coalitions of countries to address specific policy needs. For example, some or all Asian countries could create an infrastructure fund within, say, the World Bank. Projects would be managed and funded by the coalition, possibly with support from a central facility. Mechanisms of this type exist, for example, in ASEAN, which allows some members to opt out of agreements (the so-called "ASEAN minus X" approaches).

Decentralization could be achieved also through independent organizations linked together—and perhaps to a "senior" global organization—by rules and procedures. An example of such rules, albeit little used so far, is GATT Article XXIV, which establishes relationships between regional trade agreements and the global trading system. This solution would create linked hierarchies of global and regional organizations with different ownership structures. The public goods relevant to a region, for example, would be supplied by the appropriate regional unit, as suggested by the principle of subsidiarity. Regionally decentralized decision-making has the advantage of inducing large emerging economies to take leadership in providing regional public goods, even when they are not fully ready in providing global public goods. For example, PRC and India could be interested in providing funding for regional infrastructure development, opening their economies for neighboring economies to promote regional trade and investment, or working to maintain regional financial stability.

This framework is illustrated in Table 2 for the four functional areas considered in this study. We consider each of these families in further detail below.

Table 2: Institutional Families in Global and Asian Economic Governance

Function	Global Institutions	Asian Examples
Macroeconomic Stability	**IMF** *Surveillance, crisis lending, systemic stability*	**Asian Monetary Fund** (to evolve from CMIM) *Regional surveillance, crisis lending, stability*
Development finance	**World Bank** *Global public goods: poverty, environment, food* and *energy*	**Asian Development Bank** *Regional development priorities, regional infrastructure lending*
Trade liberalization	**WTO** *Global disciplines, dispute resolution, Article XXIV*	**Asia-wide FTA** (to consolidate existing FTAs) *Deeper, wider agreements*
Financial system stability	**Financial Stability Board** *Global standards, colleges of regulators*	**Asian Financial Stability Dialogue** (to be created) *Asia's regulatory initiatives*

Source: Kawai, Petri, and Sisli-Ciamarra (2010).

The institutional families: IMF, World Bank, WTO and FSB

In the area of macroeconomic stability, regional organizations—alongside the IMF—could act as "first responders" in the case of regional threats. This could avert the criticism that the IMF reacts too slowly because it represents the interests of countries outside the region, and it could better internalize spillovers among closely-linked economies. The IMF's European programs implemented in 2008-10 to address the financial crises of Iceland, Hungary, the Baltic states, and Greece represent early examples of this kind of innovation. Takagi (2009)

[17] This principle argues that there should be proper division of labor among national, regional and global institutions in providing public goods. Decisions should be made at the lowest possible administrative level that spans the benefits derived from a particular public good. For example, an Asian road network would be financed by the Asian Development Bank rather than the World Bank.

reported that the negotiations with the crisis countries also included major European stakeholders, such as the EU and the European Central Bank (and Nordic governments in the case of the Baltic states). These stakeholders contributed roughly as much funding as the IMF. The new European financial stability facility created to cope with the Greek (and potentially Spanish) sovereign debt crisis had an even larger regional component; euro-zone member countries contributed €600 billion, while the IMF contributed €150 billion. Replicating this pattern in other regions would represent a major innovation in flexibility. In Asia, for example, the Chiang Mai Initiative Multilateralization (CMIM)—and a future Asian monetary fund (AMF) to evolve from it—provides an especially opportune foundation for such decentralized responsibilities. This could also allow the emergence of a new model of Asia's collaboration with IMF as in the case of Europe.

In the area of development finance, regional development banks already exist alongside the World Bank, and the next step is to improve the division of labor between regional and global organizations. Ideally, the World Bank, should focus on global objectives and externalities, such as the Millennium Development Goals, climate change, food and energy security, and epidemics. As a central institution, the World Bank could also provide infrastructure for development finance, including the collection and dissemination of knowledge and research findings. [18] In contrast, regional development banks should focus on regional issues and externalities, such as regional infrastructure connectivity and regional environmental protection. They could also support projects funded and managed by the countries most affected by or interested in them; a good example is the creation of a Credit Guarantee and Investment Facility as ADB's trust fund to promote local-currency bond markets in ASEAN+3 countries (which include the 10 ASEAN member countries plus PRC, Japan and Korea). This would depart from current practice, which requires the majority of members of a widely-owned bank—even in the case of regional development banks—to approve its activities.

In the area of trade liberalization, global negotiations under the auspices of the WTO have stalled, while regional agreements continue to proliferate. Remarkably, there is no link today between these tracks, which should ideally coalesce into larger, even global, agreements. The WTO would have much to offer in the crafting and administering regional trade arrangements, ranging from analytical services to dispute resolution. A link between regional and global processes could address the challenge of making regional FTAs more multilateral-friendly, for example, by using standard approaches to address vexing issues such as rules of origin. In Asia, wide-ranging discussions are underway concerning the formation of an Asia-wide FTA, possibly by connecting complex, overlapping Asian FTAs into one simplified FTA. With Asian FTAs unified, it would be also easier for Asian economies to negotiate trans-regional FTAs with North America (say, through the Asia-Pacific Economic Cooperation forum) and Europe (say, through the Asia-Europe Meeting), providing a path to global integration. [19]

In the area of financial system stability, the global financial crisis has highlighted the need for an international framework for monitoring, regulating and supervising the cross-border activities of systemically important financial firms, products and transactions. The FSB has been tasked with establishing such a framework and coordinating the authorities charged with implementing it. In collaboration with the IMF, it is also charged with providing early warning of macroeconomic and financial risks and proposing actions to remedy them. The same issues are being addressed in Europe by a new European Systemic Risk Board, which will oversee macro-prudential regulation and supervision, and by a European System of Financial Supervisors for banking, insurance, and securities markets. A similar structure should also be developed in Asia. An important first step would be to create an Asian

[18] The Meltzer Report (2000) also envisioned limiting the World Bank's role to these intrinsically global public goods. However, that report saw little need for development lending beyond such public goods. In this paper, we would leave such decisions to groups of countries. They could interpret public goods differently and support projects that would not be funded by a universal membership.

[19] See Kawai and Wignaraja (2010).

financial stability dialogue (AFSD)—to be participated by finance ministries, central banks, and financial market regulators and supervisors. [20] Its task is to strengthen cross-border financial supervision and regulation at the regional level, thereby promoting Asia's financial stability, assisting longer-term financial market development, deepening and integration, and establishing standards for governance and transparency. Such an institution could play valuable roles by translating FSB initiatives into a regional context and then helping to implement them.

Regional institution building in Asia

How would Asian institutions figure in such a decentralized approach? The region has relatively few institutions of economic governance compared to other regions, aside from the Asian Development Bank. But promising seeds exist.

In the area of macroeconomic stability, the CMIM, which encompasses US$120 billion in a multilateral swap agreement and links 80% of its lending to IMF programs, could well evolve into an AMF once the IMF-link is reduced to zero. [21] For this purpose, the new ASEAN+3 Macroeconomic Research Office, scheduled to open in early 2011 should become an independent, professional secretariat, capable of creating environments for effective regional surveillance. Asia is well positioned to handle regional financial crises, given its large foreign exchange reserves. If Asian institutions—an AMF and an AFSD—took on these regional responsibilities, then the IMF and FSB could focus more attention on global risks, which should eventually become their primary concern. That work would involve surveillance of systemically important economies (the US, the EU, and the Asian region) and multilateral consultations to promote global stability.

In the area of development finance, the ADB is already quite strong. Moreover, having secured a general capital increase of 200%, it is now ready to scale up its funding to further support economic development, social progress and other initiatives. It is also helping to develop regional financial markets, including local-currency bond markets, and provides catalytic support for infrastructure investment. [22] ADB's expanding role, in turn, would allow the World Bank to focus more of its resources on truly global public goods.

In the area of trade, the seeds of a single Asia-wide FTA have been also planted. Building on ASEAN integration, so -called "plus one" free trade agreements have now been implemented between ASEAN and PRC, Japan, Korea, India, and Australia & New Zealand. Official studies have been launched for a PRC -Japan-Korea free trade area. Two region-wide FTA proposals are on the table, including an East Asia Free Trade Area (EAFTA) among ASEAN+3 countries, and a Comprehensive Economic Partnership for East Asia (CEPEA) among ASEAN+6 countries (which include all ASEAN+3 countries plus Australia, New Zealand and India). In terms of economic welfare for Asia and the world, the CEPEA is preferable to the EAFTA, but political economy considerations may dictate that an EAFTA be formed first (Kawai and Wignaraja, 2010).

In the area of financial stability there is no obvious seed for the proposed AFSD, but it is widely recognized that stronger consultations are needed among Asian financial authorities. The AFSD could be built on existing processes—meetings of the ASEAN+3 finance ministers (called the Economic Review and Policy Dialogue) and the central bank governors (called the Executives' Meeting of Asia-Pacific Central Banks, or EMEAP) [23]—by involving

[20] This was proposed by the Asian Development Bank (2008).

[21] Since many Asian economies are unwilling to enter IMF programs, the CMIM's IMF link will need to be eventually phased out. This together with a strong secretariat will transform the CMIM into an independent AMF. Then a model for IMF-AMF collaboration could be developed in line with IMF-EU collaboration.

[22] In the area of infrastructure development, a Pan-Asian infrastructure forum and an Asian infrastructure investment fund could be established. See ADB-ADBI (2009) for details.

[23] The EMEAP is a completely separate process from the ASEAN+3 finance ministers' process. Its membership includes central banks of: Australia, PRC; Hong Kong, China; Indonesia; Japan; Korea; Malaysia; New Zealand; Philippines; Singapore; and Thailand.

the region's financial sector supervisors and regulators. Since the newly established FSB does not embrace all Asian economies, the AFSD would play a critical role in regionalizing global decisions and providing regional inputs into the global process.

6. CONCLUSION

In order to achieve stable, sustainable economic growth globally, large emerging economies—particularly PRC and India—must shoulder greater responsibilities, and have their voices heard and views reflected, in global economic and financial architecture, commensurate with their rising economic weight. An important first step has been taken by including a host of emerging economies at the G20 summit process, but further changes will be required in the governance structures of key global organizations, including the IMF, World Bank, WTO and the newly created FSB.

One obvious change is to make voting shares reflect the output shares of member countries in global organizations. But broader reforms will also be necessary. We have argued that decentralizing global decisions is an important step forward. Internationally decentralized decision- making with independent, but closely linked, global and regional organizations could be more effective than centralized decision-making led by a single global organization in each of the major functional areas of global governance. This would mean some decisions would be shifted from the global to regional organizations and that some public goods would be produced not by one global organization but by several international organizations—in collaboration or possibly even competition with each other—with each accountable to its constituents. The system would be similar to that used to provide public goods within countries through multiple layers of government.

Decentralized decisions create new challenges. First, major emerging economies need to play increasingly active roles in decision-making processes and public goods provision through both global and regional organizations. Second, regional decisions need to be coherent globally in order to prevent "races to the bottom" and more generally to make such regional organizations and agreements the building blocks of an efficient global system. These are difficult issues, but a successful, decentralized system would enable the international community to respond to more problems, more quickly and more effectively. Regional organizations should address regional issues and externalities, and global organizations should in turn focus on truly global issues and global consistency.

Given Asia's rising economic weight, Asian governments and institutions will have to play increasingly critical roles in managing the global economy and finance. The ADB already plays an important role and promising seeds exist for new organizations in other functional areas of trade and finance. Asia can and should contribute more to governing today's extraordinarily complex world economy, in part by creating effective regional institutions.

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