The Summit in Seoul

After agreeing on IMF reform, the G20 faces further important decisions

By Katharina Gnath and Claudia Schmucker[1]

On 11 and 12 November 2010, the G20 countries will meet in Seoul under South Korean chairmanship. It will be the first summit at leaders' level hosted by an emerging country. During a recent meeting of financial ministers and central bank governors in Gyeongju, South Korea, the G20 proved its capacity to act by striking a long-overdue compromise to the pressing issue of IMF reforms. Nonetheless, the work of the G20 is far from complete and the upcoming summit's agenda is crowded: If the G20 wishes to establish itself as the premier forum for international economic and financial cooperation beyond the current crisis, its members have to find answers on important policy questions such as global imbalances and international financial market reforms. The G20 leaders should seize the opportunity in Seoul and find sustainable common solutions.

The G20 Deal on IMF Reform

In 2008, the upgraded G20[2] committed itself to better reflect the increased role of emerging countries in international financial institutions, and in particular to reform the International Monetary Fund (IMF). In August 2010, the United States used a procedural ploy to drive forward long-overdue reforms of the IMF governance structure: The U.S. threatened to block a decision to maintain an executive board with twenty-four members if power was not shifted toward emerging countries. In particular, European member states were urged to reduce their number of seats. After weeks of transatlantic haggling, the G20 members were able to strike a deal at their finance ministers' meeting in Gyeongj, South Korea, at the end of October 2010. Thus, one of the major objectives of this year's G20 agenda was reached before the leaders' summit in Seoul.

At the center of the IMF reform package stands (1) a quota shift by more than 6 percent in favor of large emerging countries.[3] China will become the third-largest shareholder after the U.S. and Japan. It will displace Germany—which reduced its quota share to just under 6 percent—to the fourth position among the ten most powerful shareholders at the IMF that now also include Russia, India, and Brazil. Moreover, (2) the G20 agreed to reform the composition of the IMF Executive Board. In the wake of heated transatlantic negotiations in the weeks prior to the agreement, Europe offered to give up two of its currently eight seats in favor of emerging countries. In return, the board's size will be maintained at twenty-four seats (the U.S. had initially insisted in reducing the board to its regular size of twenty members). Furthermore, some of the constituencies will increase their board representatives to two instead of one alternate director (in addition to the constituency's executive director) in order to involve more countries in the activities of the executive board. In the future, all twenty-four executive directors shall be officially elected, ending the practice of the five largest countries appointing their executive directors. Finally, (3) the Fund's current capital stock of $340 billion will be doubled. At the same time, other special funds will be reduced so that member states' overall contributions to the IMF will remain roughly the same.

The reform package should be implemented step-by-step until 2012. Formally, the IMF members still have to approve the reform.[4] Even if the necessary majorities (two-thirds of the member states with a minimum of 85 percent of the shares) are likely to be found, actual implementation of the reform will take time—most likely beyond 2012. This is not least due to the fact that it remains unclear to date how the European seats will be divvied up internally. A European reshuffle of executive directors might further lead to changes in the composition of IMF constituencies, which will also affect non-EU countries: Germany, the United Kingdom, France, and Italy will most likely keep their seats. The Netherlands, Belgium, Denmark, and possibly Switzerland will have to take turns in providing an executive director in the future.

In how far the agreed reforms of the IMF's governance structures depicts the "biggest reform ever in the governance of the institution"[5] remains to be seen. In particular, the reform's practical implications on the Fund's internal decision-making processes will be limited. However, the fact that the G20 countries kept their commitment to reform the IMF—and even exceeded expectations with regard to the timing of the compromise—carries immense symbolic importance: not only for the legitimacy of the IMF, but also for the G20's own credibility as being an effective global forum.

Key Topics of the Seoul Summit: Global Imbalances and Financial Market Reforms

After the recent agreement on IMF reform, two main issues will dominate the upcoming Seoul summit: the strengthening of the international financial regulatory system and the increasing problem of global imbalances. In addition, the Korean presidency has included new topics—including a global financial safety net and development—on the summit's agenda. This year's range of summit topics clearly shows that the G20's work program has moved from managing the immediate financial crisis to ensuring a more long-term global economic recovery.

It is likely that emerging countries will voice their interests more actively this time, particularly on the questions of global imbalances and exchange rate policy.
The G20 summit depicts a major diplomatic challenge for South Korea: the fact that an emerging country hosts a summit of this size and gets to influence the international policy agenda is an important sign of the changed balance of power in the global economy. At the same time, the summit's outcome will be a benchmark in how far the country—together with other emerging countries—can measure up to the increased global responsibility that goes along with greater economic weight. South Korea has demonstrated its skills as a host during the recent G20 ministerial meeting in Gyeongju, on which the leaders' summit will have to build on.

1) *Global Framework for Strong, Sustainable, and Balanced Growth*

The G20 leaders launched the "Framework for Strong, Sustainable, and Balanced Growth" at their Pittsburgh summit in fall 2009. Initially, the framework served to coordinate countries' exit strategies out of their economic stimulus packages. In a further step, the IMF was tasked with issuing policy recommendations in form of a "Mutual Assessment Program" (MAP) for individual G20 members. The MAPs are aimed at identifying and reducing global macroeconomic imbalances, which are considered one of the underlying causes for the current economic crisis. This topic has become more salient over the past months, as individual countries' recovery paths and economic strengths have diverged more and more: China and Germany are seeing considerable economic growth and a constant increase in current account surpluses, while countries like the U.S. register high budget and trade deficits with relatively low growth rates. In the run-up to the Seoul summit, the two sides have clashed over the viability of strengthening domestic demand in export countries as a solution to the imbalances: At the recent G20 ministerial meeting, U.S. Treasury Secretary Timothy Geithner's call to restrict current account surpluses and deficits (to a maximum of 4 percent of GDP) ran into heavy criticism by export countries with current account surpluses such as China, but also Japan and Germany.[6] Instead, the IMF was merely mandated to analyze pronounced surpluses or deficits of individual G20 countries.

The latest conflict over the pertinence of countries' exchange rate and monetary policy stance also falls within the context of global imbalances and will certainly be a prominent topic at Seoul. Over the past months, the frustration over the low external value of the Renminbi has grown within the U.S. administration: China's exchange rate policy was increasing the costs of American exports and was preventing a fast recovery—and thus a reduction of the trade deficit—of the U.S. economy. Even though China's currency has revalued faster in the past weeks against the U.S. dollar than before, the Chinese government has cautioned against too high expectations of a swift currency revaluation. In return, many emerging countries have criticized the U.S. for its loose monetary policy, which was leading to large capital inflows and to upward pressures on their local currencies.[7]

What began as a bilateral dispute on adequate exchange rate policy between the U.S. and China has escalated into a larger conflict on global capital flows and appropriate growth strategies, in which the G20 countries stand at odds with each other.[8] The outcome of Gyeongju shows that a real resolution of the underlying conflict is still a distant prospect: The last ministerial meeting of the G20 did not produce tangible solutions beyond a general declaration of intent to tackle the ongoing problem of global imbalances.[9] South Korea faces the difficult task at Seoul of acting as a neutral broker in this conflict, having become part of the conflict by carrying out currency interventions over the past months.

2) *Reforming the Regulatory Framework of International Financial Markets*

In direct response to the financial and economic crisis, the G20 decided in 2008 to overhaul the international financial regulatory framework, and the topic has dominated the G20 meetings ever since. For the upcoming summit in Seoul, the G20 countries aim to reach an important milestone—the agreement on "Basel III." In mid-September 2010, the Basel Committee on Banking Supervision presented its proposals for a reform of global banking regulation, which should be signed off by the G20 members in Seoul.[10] The key idea of the new regulation is to have more capital of better quality in order to make the international financial system more robust against future crises. Changes proposed by Basel III include, inter alia, (1) better quality of banks' core capital; (2) an increase in the required level of core capital from currently 2 percent to 7 percent; and (3) new leverage ratios for banks.[11] The tightened standards should be implemented from 2013 onward until 2019.

Basel III depicts a major reform initiated by the G20—far more significant that the much-discussed manager bonuses or tax havens of the past summits. All G20 countries—including emerging countries like China, India, and Brazil—support the Basel Committee's proposals. However, some regulatory gaps remain: for instance, G20 members could not agree on necessary liquidity reserves. Furthermore, the problem of systemic financial institutes ("too big to fail") has not been addressed yet, a topic that is particularly important for Germany. While banks' demand for capital will increase markedly in compliance with Basel III, systemically relevant capital add-ons are missing so far. Moreover, the G20 has not elaborated on an orderly restructuring procedure for systemically relevant banks. The "Financial Stability Board" was mandated with making proposals at the upcoming summit in Seoul, but further work is needed on this issue.

The current negotiations on regulatory reform of international financial markets show that the countries' willingness to cooperate on global rules is dwindling as the acute crisis is abating. Basel III, an important piece on the regulatory reform agenda, will now be realized only with a long transition phase (until 2019): The deadlines for implementing Basel III were prolonged in consideration of banks' fears of a possible credit crunch and of endangering the economic recovery. It is doubtful whether such long transition periods are really needed given that many of the international banks have already prepared for the likely capital increase due to a regulatory reform. In fact, valuable time will be lost to push forward the much-needed reforms.

Germany has attempted to include the issue of a global financial transaction tax in the upcoming summit's agenda—much to the opposition of many other G20 countries. It is unlikely that an agreement will be found in Seoul; countries' positions have not changed since the last failed attempt in Toronto in June 2010. In case of persisting disagreement at the G20 level, Germany will advance a European solution. However, opposition is stirring even at the EU level.

New Summit Issues: A Global Financial Safety Net and Development

South Korea is a strong force behind the initiative to establish global financial safety nets that should protect states against volatile global capital flows in the future. The IMF already introduced a so-called "Flexible Credit Line" (FCL) that is available to countries with sound economic data as a crisis prevention tool. In September 2010, the IMF broadened its range of lending facilities and introduced a "Precautionary Credit Line" (PCL). PCL is open to a wider group of countries including those with moderate economic vulnerabilities. Both credit lines are designed as part of a "global stability mechanism." They will be offered to countries to prevent contagion of systemic financial vulnerabilities. Yet many states—including Germany—are cautious and warn against a possible "moral hazard" resulting from those additional safety measures. The G20 will probably agree on establishing a global financial safety net in Seoul, as the issue has been one of South Korea's key agenda items. Nonetheless, opposition by countries like Germany and the U.S. will most likely dilute the final outcome considerably.

Finally, the South Korean presidency put development on the summit agenda, focusing particularly on growth, infrastructure, and trade. So far, development policy has played a negligible role in the G20. The goal for Seoul is to discuss principles of development policy within the G20.[12] The Doha Development Agenda (DDA)—although missing on the Seoul agenda—is expected to be discussed as part of the debate on development. However, Brazil is the only country that still considers the DDA to be of major importance for the G20. The topic will therefore not feature prominently in the summit's discussions.

Conclusion: The Work of the G20 is Far from Complete

By striking a package deal on IMF reform at the G20 meeting in Gyeongju, the G20 has already passed a major hurdle on their way to Seoul. Nonetheless, the agenda of the upcoming leaders' summit still bears a lot of potential for conflict. The G20 members do not form a coherent group and pursue rather different political goals resulting from distinctive challenges and experiences. (1) The controversies of the past weeks on China's exchange rate policy and the vague statements on reducing global imbalances at the recent G20 ministerial meeting are an indicator of the difficulties that the G20 leaders will face at their upcoming summit in Seoul. It is very likely that the IMF will be mandated with issuing even stronger assessments and policy recommendations for individual G20 countries. However—and contrary to U.S. Treasury Secretary Geithner's calls—it is improbable that agreement will be reached on concrete figures for current account surpluses and deficits. (2) It became clear during the Toronto summit in June 2010 that countries that had not been strongly affected by the crisis (e.g., Canada) did not see the need for stricter financial regulatory measures or a global bank levy. They were joined by many emerging countries that feared negative effects on their economic growth resulting from tighter regulation. Despite these doubts, Basel III will be adopted in Seoul. However, transition periods will be long in order to address concerns about a swift economic recovery.

By agreeing on a large-scale reform of the IMF's governance structures the G20 has shown its willingness and capacity to address global economic challenges: Given the political weight of its members, the forum is the appropriate venue to strike grand bargains—i.e., cross-issue compromises—and to assume a leadership role in questions of international economic cooperation. It is now up to the G20 leaders to find solutions for challenges that are still on the global economic agenda. Only by meeting this expectation will the G20 be able to establish itself as the premier forum for international economic cooperation in the long-run.

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Notes

[1] The policy briefing is translated from German. It was first published by the German Council on Foreign Relations (DGAP) at <http://www.dgap.org/wp-content/uploads/2010/11/2010-08_Schmucker_Gnath.pdf>.

[2] The G20 was founded in 1999 in the wake of the Asian crisis. During the first ten years of its existence, the informal forum met in the composition of finance ministers and central bank governors. In the face of the current economic crisis, the group met in 2008 for the first time at leaders' level. Members of the G20 are: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom, the United States, and the European Union. The summit in

Seoul will also be attended by the heads of the World Bank, the IMF, the Financial Stability Board (FSB), the OECD, the ILO, the WTO, and the UN. South Korea follows the tradition of inviting representatives from regional economic organizations to raise the forum's legitimacy: Ethiopia and Malawi will be present—the former representing the "New Partnership for Africa's Development" (NEPAD), the latter the African Union (AU). Vietnam is invited as chair of the Association of Southeast Asian Nations (ASEAN), and Singapore represents the "Global Governance Group" (3G). Both countries are expected to bring a stronger Asian weight to the summit. Spain will also attend the conference, being among the world's ten biggest economies and having already participated as a guest in past G20 summits.

[3] See *Communiqué*, Meeting of Finance Ministers and Central Bank Governance, Gyeongju/South Korea, 23 October 2010, <http://www.g20.utoronto.ca/2010/g20finance101023.pdf > (25 October 2010). IMF member countries contribute financially to the IMF according to a preset formula. The IMF in turn provides credits out of that capital. The number of shares determines not only the size of each country's financial contributions, but also defines the voting rights at the IMF—and therefore the overall influence on IMF policy.

[4] On 5 November 2010, the IMF executive board endorsed the reforms agreed by the G20 finance ministers. See "IMF Executive Board Approves Major Overhaul of Quotas and Governance," *IMF Press Release No.* No. 10/418, <http://www.imf.org/external/np/sec/pr/2010/pr10418.htm> (9 November 2010).

[5] IMF Managing Director Dominique Strauss-Kahn, cited in: "Strauss-Kahn says Officials at G-20 Agreed on 'Biggest Reform Ever' of IMF," *Bloomberg.com,* 23 October 2010, <http://www.bloomberg.com/news/2010-10-23/strauss-kahn-says-officials-at-g-20-agreed-on-biggest-reform-ever-of-imf.html> (28 October 2010).

[6] The current account includes trade and investment activities. Germany, for example, is expected to have a surplus of 6.1 percent this year; China will accumulate surplus in the size of 4.7 percent. In contrast, the U.S. is expected to run a current account deficit of 3.2 percent of overall GDP. See "I.M.F. Gains Sway, but Its Authority Is Uncertain," *The New York Times*, 24 October 2010, <http://www.nytimes.com/2010/10/25/business/global/25imf.html?src=busln> (25 October 2010).

[7] Germany has joined the critics of the U.S.' lose monetary policy. See "Brüderle: Lockere Geldpolitik der USA ist falsch," *Reuters.com*, 23 October 2010, <http://de.reuters.com/article/topNews/idDEBEE69M03F20101023> (25 October 2010).

[8] See Jean-Pisani Ferry, "Currency Chaos," *Project Syndicate*, 14 October 2010, <http://www.project-syndicate.org/commentary/pisaniferry6/English> (17 October 2010).

[9] The G20 finance ministers merely supported the calls to refrain from competitive devaluation of currencies and to link exchange rates closer to market developments.

[10] See Bank for International Settlement, "Basel III," <http://www.bis.org/list/basel3/index.htm> (13 October 2010).

[11] In the future, core capital (Core Tier 1) will only include common equity and retained earnings. "Hidden assets," a common feature of the German financial system, will no longer be part of Core Tier 1. Part of the increase to 7 percent of required Tier 1 capital will be in form of an additional mandatory capital buffer. The leverage ratio will be set so that capital claims cannot surpass 33 percent of the Tier 1 capital in the future.

[12]At the summit in Toronto, a working group on development was established under the co-chairmanship of South Korea and South Africa. See "South Korea puts development on the agenda for Seoul G20 summit," *The Guardian*, 4 October 2010, <http://www.guardian.co.uk/global-development/2010/oct/04/south-korea-development-g20-summit> (14 October 2010).