

GLOBAL AND REGIONAL ORDER

INTERNATIONAL INSTITUTIONAL ARCHITECTURE

Could it be saved?

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The »war« against Covid-19 will spare our physical infrastructure, but it is seriously straining the international institutions that underpin economic interdependence



As increased geopolitical tensions polarize the world, national security concerns reshape the international order to one in which deals are replacing multilaterally agreed rules.



The World Trade Organization and the International Monetary Fund are two main pillars of the architecture that has allowed the world to prosper in relative peace; preserving their relevance will require serious reforms.

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»Out of this crisis must come reforms to the international architecture and a whole new level of global cooperation«

Gordon Brown, former Prime Minister of the United Kingdom

A NEW WORLD ORDER: FROM RULES TO DEALS.

As the Covid-19 pandemic unfolds, the global economy is at the brink of one of its most abrupt and consequential shocks.¹ The pandemic has precipitated nationalist calls to repatriate supply lines for everything that could »compromise national security«. As supply shortages of medical and personal protection equipment (PPE) became apparent, governments responded by halting exports to keep »essential« goods at home.² Protecting family first is a reasonable impulse, but self-sufficiency hardliners lost no time in milking it to underscore the risks of depending on foreign suppliers.

The world economy is shifting from »just in time« to »just in case.« Uncertainty is at its peak. We ignore major questions: When will the pandemic end? What will be the cost of victory? How effective will fiscal and monetary measures be in limiting material consequences and determining whether the virus will leave long-lasting traces in consumption and behavioral patterns? Reopening restaurants does not mean that customers will be back.

We are certain that economic costs will be exorbitant. Governments in high-income countries are rapidly providing unprecedented³ amounts of fiscal⁴ and (purportedly) monetary⁵ support to their economies. However, as the impact from these measures will only come into play gradually, many of the factories, stores, restaurants, air-carriers, and hotels that are now closed may never open their doors again.

The sudden impoverishment of middle-class citizens could have far-reaching political repercussions. Millions of people have suddenly lost their jobs and now depend on state welfare checks. But it is more than jobs that they are losing. We work for an income, granted, but we also work to carve our place in society. If furloughed workers face long periods of unemployment, their skills may no

longer be in demand. Without a job, they could feel marginalized, impoverished, and deeply frustrated. Under such conditions there will be a strong impulse to scapegoat foreigners and imports for the crisis. This health crisis is a gift for nationalistic leaders.

In poor countries, social unrest could play into the hands of autocrats. China and a few other »emerging market economies« (EMEs) can devote resources to fight the virus and shore up their economies. But most developing countries have no such »fiscal space.« Nevertheless, they must cope with the virus and its economic consequences. According to the IMF, between February and March 2020, emerging market economies and developing countries lost about 100 billion US dollars in financial outflows.⁶ Moreover, the drop in global demand has affected the price of their exports (mostly commodities) and has severely reduced the hard-currency remittances that migrant workers send to their families. Many poor countries depend on these two hard-currency inflows. To make things even worse, large sections of their populations live in overcrowded slums and make their living in the form of daily cash earnings. But with the economy locked-down, housekeeping, garden maintenance, and construction gigs are no longer in demand. As poverty increases, autocrats may take advantage of simmering social unrest.

The pandemic is hitting all countries, but it is not bringing them any closer to each other. The virus targets our respiratory systems, but the impact is devastating our trust in economic interdependence.⁷ Some governments have scrambled to outbid others' imports of medical and sanitary PPE⁸ (this has happened even within well-integrated markets),⁹ while others restricted food exports.

Narrow nationalism could emerge triumphant. The origin of the virus outbreak has provided an excellent excuse to exacerbate geopolitical tensions.¹⁰ Supply chains that include China are under assault. If mutual recriminations continue to escalate, it will be exceedingly difficult to restore the minimum of »*affectio societatis*«¹¹ required for the effective functioning of multilateral institutions. Bigotry could put war (real war) back on the agenda

¹ The COVID-19 pandemic is generating the deepest global recession since the Great Depression and a stricter global lockdown than during the second world war.

² On April 24, the WTO reported that 80 countries and customs territories had banned or limited the export of face masks, protective gear, gloves, and other goods. The WTO report said that 80 countries were limiting exports of face masks and other goods.

³ The Marshall Plan, used after the second world war to reconstruct Europe, had a [in today's money is the same as saying inflation adjusted] cost of around 130 billion euros in today's money. The German government has made six times that sum available for Germany alone.

⁴ The IMF estimates that advanced economies could run fiscal deficits that, on average, may exceed 10 per cent of gross domestic product (GDP). The US fiscal deficit is projected to reach about 15 per cent of GDP.

⁵ On top of strictly fiscal measures, central banks are buying corporate and local government debt and extending loan guarantees.

⁶ The IMF reckons that in April and May emerging market sovereigns have offset the outflow by issuing new public debt for about US\$77 billion.

⁷ In a joint statement issued on April 24, the IMF and the WTO expressed concern about »supply disruptions from the growing use of export restrictions and other actions that limit trade of key medical supplies and food«.

⁸ According to press reports, in the scramble to import personal protective equipment from China, officials from France and Brazil complained that their purchases had been outbid or simply detoured by the United States.

⁹ According to press reports, some US States were outbidding others.

¹⁰ While the US has accused China of exercising undue political pressure on the World Health Organization (WHO) to play down sanitary risks, China has allowed some of its diplomats to claim (with no evidence) that the U.S. Army had developed COVID-19 as a bio-weapon and used it against China.

¹¹ *Affectio societatis* is the Latin expression meaning that two or more people wish to enter into a partnership.

Economic hardship in developing countries could send new waves of desperate migrants to the borders of rich economies. Economic growth has always depended on trade. Now political moderation does also. The buy-local fans and the national isolationists are two disparate political constituencies; yet both are pitching for a world with fewer imports. However, restricting trade would increase migration pressures.

Tariffs can stop lawful imports (and bring in more illegal immigrants). Building walls and preventing the docking of boats crowded with desperate migrants could be better at polarizing public opinion than at discouraging immigrants. Buying what they produce in their countries of origin could be far more effective. If would-be economic migrants can export what they produce in their home countries, they might not need to risk their lives jumping on rafts or paying »coyotes« to smuggle them into the promised land.

Trade could help moderate leaders preserve their jobs. As governments are borrowing to shore up domestic demand, they may want to restrict imports to keep taxpayers' money within their national borders. Fighting protectionism with lyrics on the economic benefits of free trade is pointless. However, moderate politicians will easily understand that if would-be migrants start piling up at the borders, political extremists could win the next election. Ironically, the survival of liberal democracies may hinge on low-income countries' capacity to increase their exports.

The »war« against Covid-19 will spare our physical infrastructure, but it is seriously straining the institutions that have shaped globalization. The exacerbation of geopolitical tensions is putting national security concerns at the top of the political agenda. The WTO is all but paralyzed and the rules-based trading system is cracking. The IMF is in better shape, but the financial tools it has to assist countries facing natural catastrophes¹² are insufficient to meet their needs; and it has been prevented from issuing new Special Drawing Rights (SDRs), and incapable or unwilling to use the latitude provided by its emergency provisions.¹³

Private profits with public bailouts cannot be »normal«. Globalization as we knew it was shaped by socially unsustainable rules. Capital could roam freely around the globe seeking to exploit arbitration opportunities in the areas of finance, wages, and taxes. Governments competed to retain and attract investment with subsidies, tax exemptions, and »wage moderation« policies. Ruthless risk-taking (euphemistically termed »financial innovation«) triggered a world crisis that had to be contained with public bailouts. Trade liberalization exponentially increased consumer choices and global value chains allowed many developing countries to increase both the volume of and value-added from their exports. However, the share of national income going to labor has declined in almost all G20 countries and trade rules have left no room to accommodate social concerns. Inequalities in income, wealth, and opportunity could increase even further as the economic lockdown is affecting mostly low-wage jobs that require physical presence.

»Never let a good crisis go to waste.«¹⁴ The vast and dislocating consequences of the crisis provide a fortuitous opportunity to reform the rules on which globalization was built. However, countries will only feel committed to a new set of multilaterally agreed rules if they are fairly represented at the negotiating table. This will require updating the governance structure of both the WTO and the IMF.

PAVING THE WAY FOR WTO REFORM

A problem within a much bigger problem. The WTO has been quite successful in sweeping its numerous problems under the carpet. Since January 2017 this is no longer possible, but it would be wrong to identify WTO problems with president Trump.

Paralyzed in its tracks. The WTO has two main functions: it provides a platform for countries to agree on rules for trade-related policies, and it provides a mechanism to settle trade disputes between countries. In seeking to fulfil both functions, the WTO is now virtually paralyzed.

Only lip service has been paid to reform. Much has been written about how WTO problems could be addressed, and G20 leaders have acknowledged that the WTO must be reformed. Yet no progress has been made. This comes as no surprise, as it would be pointless to get into the technicalities of WTO reform without first reestablishing a minimum of trust between the country that used to lead the multilateral trading system — i.e., the United States — and China, the country that has arguably benefited most from its current set of rules.

Only trust can pave the road to WTO reform. WTO rules were designed to regulate relations between countries where trade takes place (mainly) between private

¹² The Rapid Credit Facility (RCF) (available only for low-income countries) and the Rapid Financial Instrument (RFI) can provide urgent assistance to countries facing balance-of-payments crisis stemming from commodity-price shocks, natural disasters, conflict and post-conflict situations, and emergencies resulting from fragility. Access to the RCF is normally limited to 37.5 per cent of quota per year and 75 per cent of quota on a cumulative basis. Access has been temporarily increased from 50 to 100 per cent of quota per year, and from 100 to 150 per cent of quota on a cumulative basis. Access to the RFI is determined on a case by case basis; access to the exogenous shock window of the RCF have been temporarily increased from 50 to 100 per cent of quota per year, and from 100 to 150 per cent of quota on a cumulative basis.

¹³ Article XXVII of the IMF Articles of Agreement is the Fund's »whatever it takes« provision. It allows departing from normal practices in case of emergencies or »the development of unforeseen circumstances threatening the activities of the Fund.«

¹⁴ Winston Churchill is credited with first having said this in the mid-1940s approaching the end of the second world war.

firms that only pursue profits and commercial interests¹⁵. When China joined the WTO, the expectations were that private interests would gain preeminence, prompting China to progressively move towards the Western model of capitalism. Instead, China has been prospering on a centrally-planned capitalist model.¹⁶ This has raised concerns about China's capacity to offer substantial government financial and regulatory support to Chinese industries, both public and private. The rapid increase in China's share of global trade and state-led efforts to spur innovation have compounded suspensions on the consistency of China's economic policies with the spirit (if not the letter) of WTO rules.¹⁷

Reforming the WTO should not be about reforming China (but it should shed light on China). China would only wholeheartedly engage in WTO reform if it were reassured that such reform will not be used to impose the Western model of corporate governance. Using firms (private or public) as instruments to achieve economic and social objectives is not necessarily inconsistent with the multilateral trading system. However, WTO reform must provide tools to shed light on the role of governments in corporate decisions. Marshalling political agreement on this broad objective could be a first step in a wider reform effort at the WTO.

Developing countries should eventually develop. A second political agreement would be necessary to kick-start frank negotiations. The WTO currently has 164 members, about two-thirds of which have declared themselves »developing countries.« The WTO grants »Special and Differential Treatment« (S&D) to all developing countries. S&D provides longer periods to introduce less ambitious tariff reductions. Status as a developing country is self-determined and unilaterally declared to the WTO. As there is no benchmark to assess when a country »develops,« nor any agreed indicator to determine when some of its industries could be weaned from S&D, WTO »developing« countries do not ever »develop.« Neither do they relinquish the S&D benefits for some of their industries.

A fossilized »Special and Differential Treatment« has created a perverse feedback loop. Developing countries complain that many of their S&D »benefits« are of little or no help. They rightly note that many are drafted in exhortatory language, and that developed countries have refused to add substance to them. This has bred frustration in the »developing« camp, which in turn has refused to consent to new negotiations aimed at updating and adapting trade rules to new economic realities.¹⁸

Dealing with taboo. With no agreed benchmark by which to ascertain the degree of development, nothing prevents China from claiming that it needs S&D. This flies in the face of its leading role and is a political irritant that obstructs the US's engagement with the WTO.¹⁹ In February 2019, the US proposed criteria for »graduation« from developing country status. These criteria were forcefully rejected by China and India. Meanwhile, the incongruity between an evolving economic reality and a fossilized set of S&D rules is pushing trade negotiations out of the WTO.

Time to have a candid conversation. Agreement on this highly politicized issue could be exceedingly difficult if countries engage in an abstract controversy on who is developed and who is (still) developing. Rather, governments could engage in a quiet and rational discussion about what kind of S&D could effectively support their domestic efforts to develop competitive industries. Such a discussion could be facilitated by an analysis of how some »developing« countries have successfully developed world-class industries that now compete in the international market.

A developing country in Geneva, but a grown-up in Washington. Ironically, while in Geneva »developed« countries argue that big EMEs must assume equal trade obligations, in Washington they staunchly resist the emerging market economies' struggle to assume increased responsibilities at the International Monetary Fund (IMF, or »the Fund«).

PAVING THE WAY FOR IMF REFORM

Lending and supervising: two very disparate functions. The IMF manages a pool of international resources to assist countries in financial distress. It is mostly known for this »lending«²⁰ function, but it must also exercise surveillance over the economies of all its members, including those from which the Fund borrows rather than lends.

Money for votes. As an uncompromising supervisor, the IMF is called upon to speak truth to power, blowing the whistle where it sees problems and providing spontaneous and independent policy advice. However, countries that contribute more to the IMF's pool of resources have more votes, hence more influence in the Fund's decisions. Arguably, it makes perfect sense to allocate votes according to the size of contribution, or at least regarding decisions on the use of the Fund's resources. However, not all IMF decisions are related to the use of its financial resources: many are about how it exercises surveillance and how it communicates its results; yet all decisions are taken by »weighted voting.«²¹

¹⁵ State-owned enterprises are required to act in accordance with commercial considerations. Article XVII of the GATT 1994.

¹⁶ In China, the state retains a majority share in all but one of the 100 largest publicly listed companies.

¹⁷ Excess capacity in some energy and manufacturing sectors and implicit assistance to (and through) state-owned enterprises (SOEs) have increased.

¹⁸ See Concluding Remarks, p. 46. Revitalizing Multilateral Governance at the World Trade Organization.

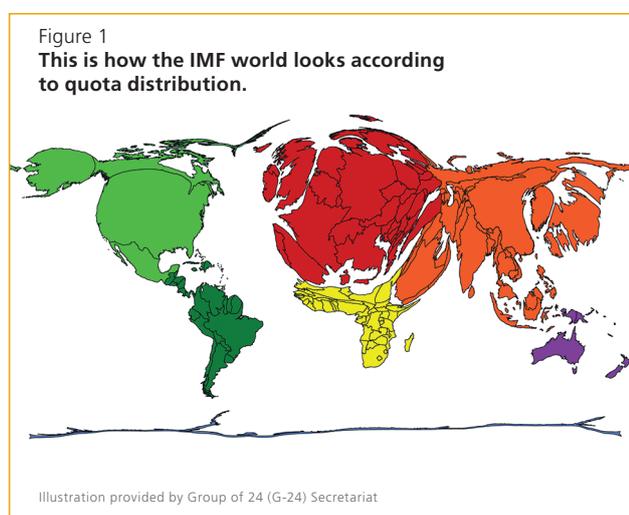
¹⁹ President Trump has recently railed against China's self-declared developing country status at the WTO, saying that the U.S. should be able to call itself a developing country if China can.

²⁰ Members draw on the IMF's pool of currencies and SDRs through a purchase-repurchase mechanism.

²¹ The IMF says that decisions are taken by »consensus.« However, in practice this is simply a way to avoid casting votes. After discussing a subject, the chair of the Executive Board assesses whether the proposed decisions have sufficient »weighted support,« in which case she proposes to adopt it by »consensus.«

The credibility of the IMF's policy advice rests on its capacity to exercise arm's-length and evenhanded surveillance over all its members, regardless of the size of their quotas. Exchanging money for votes conflicts with the IMF's capacity to exercise even criticism across its members. This was exposed by the report produced by the IMF's Independent Evaluation Office on the Fund's role in the run-up to the 2008-2009 financial crisis.²²

Tailoring quotas to preserve influence. The difficulty of using the same governance structure to serve both the IMF's »lending« and its surveillance function is compounded by the fact that IMF quotas don't even reflect its members' relative weight in the world economy. Far from it: IMF quotas are calculated using an arcane formula²³ that allocates exaggerated influence to European members.



Ready to play in the IMF's top tier division (but not in the WTO's). (See Figure 1) Large emerging-market economies are ready to undertake more responsibilities in the IMF. Accordingly, they want to increase the weight of GDP (measured in PPP terms) in the IMF's quota formula. This would allow them to pay larger quotas, commensurate with their augmented weight in the world economy. IMF countries have agreed to adopt »a new quota formula,« but since allocating IMF quotas is tantamount to allocating influence on IMF decisions, tinkering with the quota formula has proven to be exceedingly difficult. »Advanced economies« (IMF jargon for »developed« countries) are

resolutely opposed to such a reallocation.²⁴ This contrasts sharply with what is going on in Geneva. As noted above, in the WTO it is developed countries that want fast-growing emerging markets to assume equal responsibilities, while these prefer to depict themselves as developing countries in need of »special and differential treatment.« (See Figure 2)

Weighted voting without weighted influence. Allocating votes according to countries' capacity to contribute to the IMF pool of resources raises two challenges. Firstly, ensuring that the vote/quota-allocation can periodically accommodate changes in countries' relative weight in the world economy. Secondly, ensuring that weighed voting does not translate into »weighted influence« on the supervisor. The IMF has problems on both counts.

A North-Atlantic IMF.²⁵ Not every country has the same economic performance. Some countries grow faster and richer than others. The world economy is permanently reshaped, and changes should be periodically reflected in adjustments to the size of countries' subscriptions (quotas) to the IMF pool of resources.²⁶ Alas, this does not happen as it should.²⁷ As noted above, the quota formula used to calculate contributions to the IMF pool of resources fails to reflect adequately changes in countries' shares of world output. Even if countries could agree on a »new quota formula,« they would still need to agree to run it periodically and allow quota increases to rebalance contributions.²⁸ This does not happen²⁹.

²² The IEO has detected that the IMF has exercised more zeal in the surveillance of the economies of developing than in those of developed countries (where the recent economic crisis started).

²³ Quotas are calculated using a weighted average of GDP (weight of 50 per cent; measured as a blend of GDP at market exchange rates, 60 per cent, and on GDP at purchasing-power-parity exchange rates, 40 per cent), openness (30 per cent, measured as the annual average of the sum of current payments and current receipts of goods, services, income, and transfers for a five-year period), »economic variability« (15 per cent based on current receipts and net capital flows, measured as a standard deviation from the centered three-year trend over a 13-year period), and international reserves (5 per cent). The formula also includes a »compression factor« to reduce the dispersion in calculated quota shares across members.

²⁴ Resistance comes mostly from the EU and from Japan (which could lose its status as the holder of the second biggest quota to China). Increasing the weight of GDP (either measured in nominal terms or purchasing-power parity) would only marginally affect the US quota share, but Washington would not like to see China's influence increased.

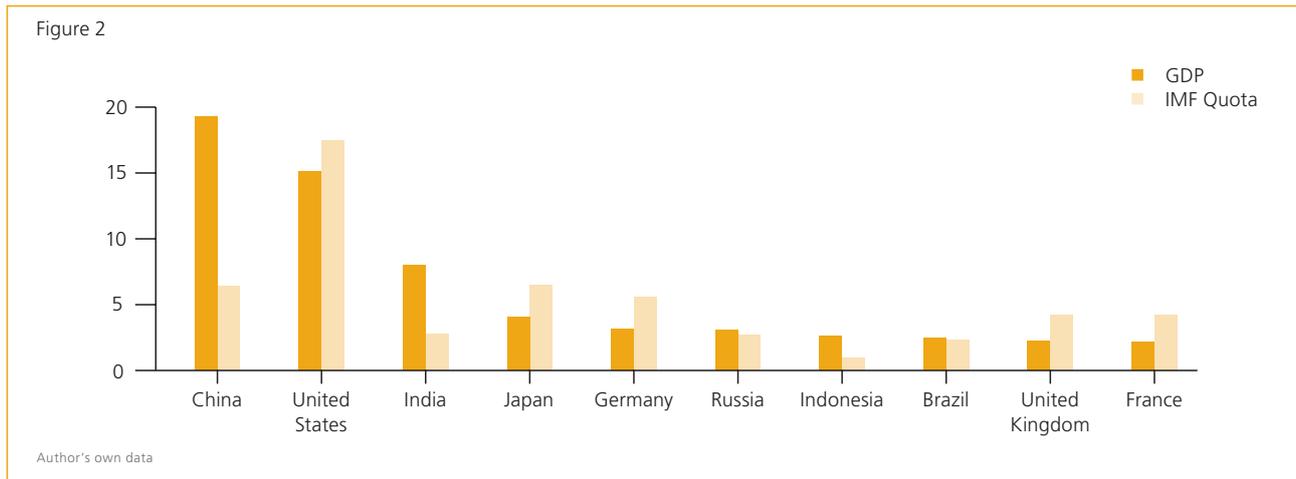
²⁵ European Members have always been able to count on US support to appoint a European as the Fund's managing director. This has corresponded with the US' »right« to count on European support to appoint the World's Bank president.

²⁶ Article III, Section 2 »Adjustment of quotas« establishes that the Board of Governors shall conduct general reviews of quotas »at intervals of not more than five years« and propose adjustments »if it deems it appropriate.«

²⁷ »The distribution of IMF quotas is intended to reflect the relative weight and role of its members in the global economy. But relative quota shares among members have changed only gradually and have not kept up with changing economic realities.«

²⁸ Rebalancing quotas would be politically very difficult without allowing for quota increases.

²⁹ General Quota Reviews (GQRs) should take place every five years. These provide opportunities to increase IMF capital and to rearrange quotas according to changes in countries' weightings in the world economy. The 14th GQR approved a 100 per cent increase in quotas. This increase allowed the IMF to allocate larger quotas to the countries that were the most underrepresented (notably China, whose voting power increased from 3.803 per cent to 6.09 per cent). It was adopted in 2010, but the United States delayed approving it until December 2015. The 15th GQR was supposed to be concluded in January 2014 but made no progress. In March 2018 the G20 reaffirmed its »commitment« to a »strong, quota-based, and adequately resourced IMF« and pledged to agree on »a new quota formula as a basis for a realignment of quota shares to result in increased shares for dynamic economies in line with their relative positions in the world economy and hence likely in the share of emerging market and developing countries as a whole«; and to conclude the review »no later than the Annual Meetings of 2019.« However, the 15th GQR squarely failed. In February 2020, the IMF Board of Governors concluded the review with no increase in IMF quotas.



Technically pure (but politically tarnished) recommendations. Unequal influence on the IMF's governance structure raises questions about the technical purity of its policy advice. Real or perceived conflicts of interest may arise as influential members can find ways to press for »technical« recommendations that fit their political expectations. This harms the credibility of the IMF's recommendations and explains (and frequently justifies) the secular concerns of EMEs and developing countries regarding the Fund's lack of »evenhandedness.«³⁰

Feeling ownership of the Fund's policy advice. To buttress the Fund's credibility and countries' ownership of its policy advice two reforms are necessary: firstly, ensuring a fair representation of countries in IMF quota allocation and, secondly, limiting the capacity of its most influential members from exercising undue influence on the IMF's policy advice.³¹

FINAL REMARKS

There is a contrasting symmetry between governance reforms that could simultaneously fortify support for the IMF and the WTO. The WTO and the IMF are central to the institutional architecture on which international economic cooperation rests. Both face an existential challenge because both are in denial of real-economy changes. Large emerging markets should assume obliga-

tions and responsibilities commensurate with their increased economic weight. This will require reforming the governance of the IMF and the WTO. This will not be an easy task, but synchronizing both reforms would facilitate political trade-offs.

Countries like China and India will not accept first-class citizens' obligations at the WTO if they continue to feature in the IMF's low-league players list. Vice versa, it will be exceedingly difficult for the US and the EU (albeit for different reasons in each case) to accommodate China and India at the IMF podium if they still claim to need special and differential treatment at the WTO.

Where could discussions on such a trade-off take place? The pandemic has underscored the importance of having well-functioning multilateral institutions that can preserve economic cooperation. Promoting coherence among multilateral institutions and economic policies is central to the G20's remit. However, given the geopolitical tensions that are poisoning international relations, striking trade-offs will require the active engagement and artful diplomacy of middle-powers and the EU.

When could discussions take place? Preparing the terrain will require raising awareness of the opportunity to advance with symmetrical reforms in the WTO and the IMF. A group of respected and independent experts could facilitate policy-makers' task by providing dispassionate analysis and by proposing a menu of action-oriented proposals to advance with balanced reforms in Washington and Geneva.

³⁰ The Group of Twenty-Four (an Intergovernmental Group that advocates for the interests of EMEs and developing countries in the IMF and the World Bank) has traditionally insisted on the importance of ensuring evenhanded policies and their implementation. At its last Ministerial Meeting (October 12, 2017), the Group issued a Communiqué calling for »(...) evenhanded surveillance and lending decisions, and for the extension of the mandate of the IMF's Evenhandedness Committee to include the Fund's lending activities.«

³¹ The purpose of this paper is not to prescribe possible reforms, but rather to prompt a discussion on practical ways to deliver incremental improvements in the IMF's governance structure. Having said this, the reader may want to reflect on the possibility of limiting weighted voting to IMF decisions concerning the actual use of IMF resources, in establishing a double-voting mechanism (like the one used in the EU) for all other decisions, and in establishing an ombudsman who could »ex-officio« scrutinize the IMF's surveillance function to detect and publicly report cases of lack of evenhandedness and/or undue use of influence.

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INTERNATIONAL INSTITUTIONAL ARCHITECTURE

Could it be saved?



The »war« against Covid-19 will spare our physical infrastructure, but it is seriously straining the international institutions that underpin economic interdependence.



As increased geopolitical tensions polarize the world, national security concerns reshape the international order to one in which deals are replacing multilaterally agreed rules.



The World Trade Organization and the International Monetary Fund are two main pillars of the architecture that has allowed the world to prosper in relative peace; preserving their relevance will require serious reforms.

Further information on the topic can be found here:
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