

# 5

## External monetary and financial policy: a review and a proposal

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To the question 'How does the EU organise its external monetary and financial relations,' the immediate answer is 'not easily'<sup>2</sup>. One source of complexity is that international monetary and financial relations are organised as an overlapping set of institutions and groupings in which participation and representation are heavily influenced by political and historical circumstances.

European countries are generously represented in these institutions (see Table 5.1), but their representation bears only a loose relationship to the current condition of the world economy. European countries have eight members on the 24-person Executive Board of the International Monetary Fund (nine when Spain periodically chairs its predominantly Latin American constituency). This is because a set of small European countries had a head start in their industrial and financial development and figured disproportionately in international trade and financial transactions when the Fund (IMF) was established in 1944, and because representation in these institutions is slow to change.

The G10 is constituted as it is<sup>3</sup>, with seven European members, because a handful of European countries had substantial dollar balances in the 1960s, making them the logical parties to address the US gold problem that dominated the international monetary agenda at the time. The G7 is made up as it is, with a majority of European members, because the states in question were the obvious candidates for the steering committee for the international monetary and financial system when the latter entered a period of flux in the 1970s. European countries are therefore generously represented in all of the venues in which international monetary and financial relations are considered.

Table 5.1: Selected international forums, member countries\*

| IMF Executive Board | G7             | G10**          |
|---------------------|----------------|----------------|
| Germany             | France         | Belgium        |
| France              | Germany        | France         |
| United Kingdom      | Italy          | Germany        |
| Belgium             | United Kingdom | Italy          |
| Netherlands         | Canada         | Netherlands    |
| Italy               | Japan          | Sweden         |
| Finland             | United States  | Switzerland    |
| Switzerland         |                | United Kingdom |
| United States       |                | Canada         |
| Japan               |                | Japan          |
| Venezuela           |                | United States  |
| Australia           |                |                |
| China               |                |                |
| Canada              |                |                |
| Egypt               |                |                |
| Saudi Arabia        |                |                |
| Malaysia            |                |                |
| Kenya               |                |                |
| Russian Federation  |                |                |
| Iran                |                |                |
| Brazil              |                |                |
| India               |                |                |
| Peru                |                |                |
| Rwanda              |                |                |

\* European countries listed first.

\*\* The G10 was established in 1962; Switzerland joined in 1964.

The question is whether this situation is sustainable in a world where the balance of economic power is shifting toward emerging markets. The increasingly evident answer is 'no'. The underrepresentation of emerging markets on the boards of the IMF and World Bank is the mirror image of Europe's overrepresentation. The danger is that emerging markets, having accumulated massive amounts of international reserves, may set up regional rivals to these multilateral institutions so that they have more voice in deciding their financial fate. In addition, in September 2006 the United States and China agreed to conduct regular bilateral consultations. The first of these talks took place in Beijing in mid-December 2006 and the US delegation included senior officials such as Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke. One can imagine how these consultations could develop into an alternative to the G7 process, since China – soon to be the world's

second largest national economy – is unrepresented there. If Europe refuses to share its place at the table, it may find itself increasingly short of dining partners of consequence.

The other source of complexity is Europe itself. Switzerland is a member of the G10, which is appropriate insofar as its policies have an impact on international financial markets, but it is not a member of the European Union. That Norway is a large reserve holder and sometime chair of an IMF constituency but not an EU member, is a source of additional complication. The United Kingdom is a member of the European Union but not of the euro area<sup>4</sup>. In addition, membership is not static: the composition of the EU and the euro area has and will continue to evolve.

There are a number of different ways of organising Europe's external monetary and financial relations:

- Foreign financial and monetary policy could remain, as has traditionally been the case, a national competence. It is said that there is no more appetite in Europe for a single foreign financial policy than for a single foreign policy generally<sup>5</sup>. This implies at most updating the prevailing state of affairs to remove the worst inefficiencies but not changing it fundamentally.
- Member states could more closely coordinate their international monetary and financial policies in order more effectively to counterbalance the United States and advance the common European position – on the assumption that there is in fact a common European position.
- Finally, Europe's representation in international forums could be unified. This would entail delegating responsibility for its formulation to the European Commission and appointing a single EU representative to communicate with the Union's interlocutors in the various global forums.

This is, of course, just a specific instance of the larger debate over which competences should be assigned to the European Union and which responsibilities should continue to reside with the member states. The European convention that met from 2002 through 2004 to decide on a draft treaty establishing a Constitution for Europe, and the subsequent difficulties in ratifying the draft treaty, remind us that Europe has not yet reached the nirvana where there exists agreement on a particular approach<sup>6</sup>.

How then should European countries and their citizens go about reaching such agreement? The theory of fiscal federalism provides the standard tools for deciding how responsibilities should be allocated across levels of government. It suggests

assigning to the most encompassing level of government, in this case the EU, issues where tastes are homogeneous and where there exist economies of scale associated with centralised provision – and, conversely, leaving to lower levels of government, in this case the member states, issues over which national tastes diverge and economies of scale are absent. In the present context, the existence of economies of scale in provision means that Europe's positions in international forums can be represented more effectively when representation is centralised; Europe will be better able to express and achieve its goals. Homogeneity of tastes means that European countries have similar objectives and foreign policy goals. We will argue that foreign monetary and financial policy comes reasonably close to qualifying on both counts. Thus, we conclude that Europe should move toward closer coordination and greater centralisation of its representation in external monetary and financial affairs.

If this hypothesis is correct, it points to the difficult question of why the EU has not already delegated responsibility for formulating a common position on monetary and financial affairs to the Commission. Some will say that its reluctance to do so falsifies the hypothesis – that either we exaggerate the efficiency advantages of centralised provision, or else we minimise the extent of preference heterogeneity. The failure of member states to assign their foreign financial and monetary policies to the EU is *prima facie* evidence against the hypothesis.

An alternative is that the null is correct but there are significant fixed costs of change. For instance, negotiating a change in EU constituencies in the Bretton Woods institutions involves negotiating with non-EU countries, which in many cases cohabit with EU member states in the same constituency<sup>7</sup>. It means asking EU members that presently chair constituencies to give up that privilege in favour of a single EU chair. Inevitably these negotiations will force governments to expend valuable political capital. Moreover, policymakers are risk averse, which creates a status-quo bias. Uncertainty about whether change will really deliver a welfare improvement lends inertia to existing arrangements. Thus, even though consolidated European representation would be better, inertia has prevented it from taking place. Sympathetic as we naturally are to our own hypothesis, we are more inclined to this interpretation of the facts.

This interpretation points to the need for a strategy for overcoming status-quo bias. Here we build on theoretical work inspired by the problem of transition from plan to market in the formerly centrally-planned economies, in the context of which it has been argued that experience with limited reform may help to convince otherwise sceptical stakeholders of the positive effects of further reform (Dewatripont and

Roland 1992). This suggests investing first in the development of unified representation and common policies toward a set of issues and in a venue where the case for doing so is strongest. If the results convince the sceptics that this enhances the efficiency and effectiveness of Europe's voice and influence, without forcing unacceptable compromises in national positions, it may be possible to emulate this example in other venues and issue areas.

Concretely, we recommend starting by consolidating Europe's representation at the IMF. One can imagine consolidating Europe's representation into a single chair or a pair of chairs, one for the members of the euro area and the other for other EU countries. (Our incremental approach emphasising the advantages of learning by doing suggests starting with a pair of chairs). The rationale for consolidating EU representation at the IMF is stronger than the analogous rationale for doing so at the World Bank, G7, G10, G20 and Financial Stability Forum. In the case of the IMF, the infrastructure needed to establish a single European position is relatively well advanced. Increasingly, the reluctance of EU member states to give up their seats on the IMF Executive Board is seen as a major obstacle to comprehensive governance reform and thus as undermining the legitimacy of the institution<sup>8</sup>. Europe is going to have to negotiate over these issues whether it commits to unified representation or not. It might as well make the most of the process.

The IMF is also the right place to start because preferences on IMF-relevant issues are relatively homogeneous. To the extent that the IMF is historically concerned with issues revolving around exchange rates, the fact that half of EU members have the same currency and therefore the same exchange rate points strongly in this direction. That the euro area, not individual member states, has been invited to participate in the IMF's first multilateral consultation on the topic of global imbalances is more evidence of the point.

Finally, the IMF is the right place to start because economies of scale in representation are strong. Analytical work by Leech and Leech (2005) and Bini-Smaghi (2006b) suggests that a single seat, or even a pair of EU seats, will make the EU, with its cohesive block of votes, a key swing voter. The EU will be better able to achieve its goals, which is precisely what is meant by economies of scale in provision and representation. Another factor reducing the costs of moving in this direction is that the EU has already made progress in coordinating national policies in the Fund by creating SCIMF, a subcommittee on IMF-related issues in the Economic and Financial Committee, for which the Directorate-General for Economic and Financial Affairs ('DG Ecfm') of the European Commission acts as secretariat, and EURIMF, an informal committee of EU countries' representatives in the IMF.

Thus, the three key considerations – negotiating costs, preference homogeneity, and economies of scale in provision – all have as their starting point the rationalisation of Europe’s representation at the IMF<sup>9</sup>. If doing so proves successful, EU member states will then be more likely to contemplate similar reform in the case of other issue areas and venues.

### **The state of play**

A traditional reason for scepticism that the EU is prepared to cooperate more closely in managing its foreign monetary and financial affairs is that it has not made much progress in cooperating on foreign policy more broadly. After all, foreign monetary and financial policy is simply a subset of foreign policy generally. Preferences are heterogeneous. For example, European countries have different attitudes regarding the extra-European powers: consider the UK’s special relationship with the United States, France’s long-standing ties with Russia, or Germany’s historical and current economic connections with Turkey.

It is tempting to make the same point with respect to monetary and financial affairs. From the founding of the modern G10, France has been more sceptical than other European countries about the exorbitant privilege of the United States in the international monetary system. Germany has been especially concerned about the moral hazard and inflationary bias associated with international rescue packages. The UK has been relatively keen on financial deregulation and liberalisation, seeing this as giving London an advantage in the competition for international financial business. The Netherlands and the Scandinavian countries have placed a priority on development assistance and concessionary finance for the poorest countries. Every EU country that had colonies feels a special responsibility for its one-time possessions and feels that monetary and financial policies should be adapted to help meet their special needs.

At the same time, foreign monetary and financial policies clearly differ from other foreign policies. To date 13 European countries share a single currency and they can only have a single exchange rate against the dollar. They can only have a single foreign exchange market intervention strategy. They must take a single decision on whether to adapt monetary policy to exchange rate developments and to conditions in the rest of the world. They must reach a collective view on the immediacy of economic and financial risks and on how the ECB should respond. The very existence of monetary union is an indication that there exists a relatively high degree of preference homogeneity in this domain. The fact that 13 European countries share a single currency and single central bank shows that there should be economies of scale from

greater centralisation of Europe's representation in arenas concerned with international monetary and financial affairs.

Not surprisingly, the result is a compromise in which member states and the EU institutions share competences. The member states remain the dominant players, reflecting the weight of history and institutional inertia. The Treaty of Amsterdam (1997), in which the member states sought to take the external monetary and financial implications of the euro on board, stated that 'the Council, acting by a qualified majority on a proposal from the Commission and after consulting with the ECB, shall decide on the position of the Community at the international level as regards issues of particular relevance to economic and monetary union and on its representation...' Thus, the Council, where the member states are represented, retains the power to decide whether or not there will be a common European position, although the Commission and the ECB both have agenda setting power.<sup>10</sup>

At the European convention, the idea of unified representation for the EU was advanced by the Parliament and the Commission. Pedro Solbes, then EU economic and monetary affairs commissioner, made declarations both inside and outside of the convention in favour of a single EU representative on the IMF Board (Louis 2003). The draft constitution sought further to amplify the voice of euro area countries by authorising the Eurogroup to elect a president for two and a half years to represent the euro area on the international stage. It proposed to allow euro area members to decide, voting among themselves, on financial relations with the outside world. The Eurogroup would be allowed to decide 'positions on matters of particular interest for economic and monetary union within the competent international financial institutions and conferences.' But the implications for unified representation were tempered by other provisions making clear that decision-making authority still ultimately resided with the member states represented in the Council of Ministers. In particular, the draft constitution empowered the Council to 'adopt appropriate measures to ensure unified representation within the international financial institutions' (Corrales-Diez 2003).

In practice, member states have concentrated on coordinating their policies without pressing for actively unifying their representation. It was agreed at the informal Council of Ministers ('Ecofin') meeting in Oviedo in 2002 that the EU should rely on informal coordination in order to develop common positions (Crelo 2005). There are no *ex ante* commitments to develop common positions. EU representatives are encouraged to coordinate their views, but nothing commits them to doing so.

Arguably, soft coordination has increased since Italy's presidency of the EU in the

second half of 2003. Some observers attribute this to officials like Lorenzo Bini-Smaghi, who long stressed its desirability. The focus of this process is weekly meetings of European executive directors (EDs) in both the IMF and World Bank. Their goal is to discuss national positions and, where interests coincide, to devise strategies for pursuing them.

### ***The International Monetary Fund***

These arrangements are relatively well developed at the IMF. SCIMF prepares the work of the Economic and Financial Committee (EFC: high-level finance ministry and central bank officials) on IMF and related issues. (SCIMF was set up as a working group in 2001 and made a permanent subcommittee of the EFC in 2003). It meets in Brussels roughly eight times yearly and comprises representatives of each country's finance ministry and central bank plus two from DG Ecfm and two from the ECB. The Commission acts as SCIMF's secretariat, preparing agendas and minutes, although it does not take an active part in discussions. The two members of DG Ecfm speak in meetings on behalf of the Commission but do not vote. The European executive director chairing EURIMF also attends these meetings to ensure consistency with what goes on in Washington DC.

Documents agreed by SCIMF go first for endorsement to the EFC and are then transmitted to European EDs at the IMF. However, EDs are not obliged to follow them. Moreover, the fact that meetings occur at roughly six-week intervals can be a problem, since SCIMF does not always meet with the timeliness needed to feed opinions and common positions to members of the IMF Board (Eurodad 2006). This is indicative of the limits of soft coordination.

Complementing SCIMF is EURIMF, a grouping of all EU countries' representatives in the Fund established in 1998 to foster EU coordination. A representative from the Commission Delegation in Washington and one from the ECB participate in this group. The core of EURIMF activities is the 'EU presidency grey mechanism'. Before each board meeting, each constituency prepares a position paper known as the 'grey'. On questions relevant to the EU there is a coordination of greys. In addition, the European ED chairing EURIMF may make an introductory statement at IMF Board meetings on issues related to the world economy that reflects the common European view<sup>11</sup>.

Finally, there are ad hoc 'one-per-chair' or 'one-per-office' meetings. These gather representatives of European countries occupying chairs on the IMF Board. They function as a kind of mini-EURIMF.

Importantly, the ECB is not represented in these meetings. This situation changes slightly when deliberations move to the Executive Board, where the ECB has observer status. The ECB is empowered to speak in Board meetings on matters of European monetary policy – for example, on staff reports on Article IV consultations with the euro area – but only if it is first admitted to the floor.

In 1998 the Commission proposed that it should also enjoy observer status – more precisely, that the executive director of the member state holding the euro area presidency ‘assisted by a representative from the Commission’ would represent the euro area in Executive Board meetings. However, the Council rejected the Commission’s proposal on the grounds that accepting it would be seen as ceding authority [Corrales-Diez 2003].

Some officials argue that IMF surveillance suffers from the fact that the president of the ECB has only observer status on the International Monetary and Financial Committee (IMFC), where a number of central banks are represented. At the spring meetings of the IMF in 2006, Eurogroup President Jean-Claude Juncker (Luxembourg’s Prime Minister) diplomatically described this as “stupid and ridiculous”<sup>12</sup>. The president of the Eurogroup of finance ministers is represented but only if a place is surrendered [Atkins and Schieritz 2006]. To be sure, the finance minister of the country holding the presidency of the EU Council of Ministers delivers a speech at the IMFC biannual meetings. But that speech, prepared by SCIMF in Brussels, is a very general document, since it must reflect the common ground of all members. Hence it lacks specifics and has little ability to shape the agenda. And the fact that the EU presidency rotates every six months undermines continuity and the establishment of durable contacts between the EU presidency and IMF staff [Eurodad 2006, Phillips 2006b].

### ***The World Bank***

EU participation at the World Bank is less advanced; no EU institution even possesses observer status on the Board. While the Commission is an observer in the joint IMF-World Bank Development Committee, as an observer it does not have the right to speak nor is it provided with internal documents [Phillips 2006b]. Since 2004 the EU commissioner for development has made a speech on behalf of the European Community to the Development Committee, but again it is not formally represented [Eurodad 2006].

European representatives at the Bank meet regularly in Washington, but no structure analogous to SCIMF exists in Brussels. Since 2000 several European presiden-

cies have attempted to organise meetings in Washington focusing on World Bank board agendas. In November 2003, Europeans signed an agreement stipulating that such meetings should occur every two weeks and possibly more often. In practice they have occurred once a week, usually on Fridays. The main function is to exchange information. An official from the Commission's delegation in Washington attends these meetings as an observer (Eurodad 2006).

As at the IMF, coordination is hindered by the fact that some member states are in joint constituencies, while others have constituencies of their own. Coordination is further complicated because, compared to the IMF, there is greater heterogeneity of background among European EDs, about half of whom come from finance ministries, a third from development and cooperation ministries, and the rest from foreign ministries.

Despite all this, European directors have occasionally issued joint policy statements, such as their statement of support for the Wolfowitz candidacy for the Bank's presidency. In November 2003 European EDs agreed on a list of procedural issues of common interest (Eurodad 2006). However, directors in joint constituencies did not participate (Phillips 2006b).

### **G7/8**

At G7/8 meetings, the ECB represents the European monetary authorities when monetary and financial issues are discussed. But in the remainder of the meeting the ECB leaves in favour of the heads of the national banks of France, Germany and Italy (Truman 2004). The president of the Eurogroup participates, but so do the three European finance ministers.

Predictably, the big EU member states that monopolise representation in the G7 are not keen on sharing it with smaller member states. This creates problems when the G7 drafts initiatives that commit other member states, as was the case with the recent Multilateral Debt Relief Initiative (Phillips 2006b). Munchau (2006) has called for replacing the G7/8 with a G4 composed of the US, the euro area, Japan and China. Kenen *et al.* (2004) have called for replacing it with a Council for International Financial and Economic Cooperation with the US, the euro area, China, Japan and the UK as permanent members and ten other countries rotating on and off. Countries like Italy, France and Germany (not to mention the UK, in the Munchau variant) that face losing national representation will presumably resist either proposal in the absence of further steps to establish a common European position and agreement on the desirability of assigning such competences to the euro area or EU institutions.

### ***Financial Stability Forum (FSF)***

The Financial Stability Forum was created in April 1999 in the wake of the Asian crisis to address issues of systemic stability in international financial markets. Its members include national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. Of the EU countries, France, Germany, Italy and the UK have their central banks, finance/economy ministries and securities regulators represented, while the Netherlands has its central bank. Other European countries are not represented. The ECB is represented but not the Commission. There is little evidence of institutional progress toward the coordination of European policies on the FSF.

### **How has the state of affairs affected particular issues?**

We now consider how this state of affairs has affected particular issues such as IMF policy, exchange rate policy, and the correction of global imbalances.

#### ***IMF policy***

Compared to the United States, European countries have tended to adhere to a hard line on the extension of IMF assistance to crisis countries. European directors have regularly argued that IMF loans should be subject to explicit ceilings as a way of addressing moral-hazard problems. More recently some have suggested that exemptions from the conventional 300 percent of quota limits should require an open letter from IMF staff explaining in detail why an exception is proposed. Various directors have also suggested that agreement to waive normal access limits should require a supermajority vote (National Bank of Denmark 2001).

But this scepticism about the merits of large loans has not prevented the granting of them. Thus, while two European directors dissented from the decision to provide another loan to Argentina in August 2001, this did not prevent that loan from being granted, largely on the initiative of the United States (Mussa 2002). One can imagine that things would have been very different had Europe been able to speak with one voice.

European countries have also been in the vanguard of IMF members pushing for a more rules-based approach to sovereign debt restructuring. A number of European countries strongly supported the proposal for a Sovereign Debt Restructuring Mechanism (SDRM), which would have specified procedures for officially-led

restructuring negotiations. But the constituency to which Spain belongs opposed the SDRM, since the views of emerging-market borrowers in that constituency – Venezuela, Mexico and Colombia in particular – prevailed. The UK was sceptical, since it was accustomed to a contractual approach to restructuring (through the use of collective action clauses) rather than a statutory process. One can imagine that the European view would have carried more weight had all European countries lined up behind it.

Finally, European countries have punched below their weight in the debate over reform of the internal organisation and day-to-day operations of the organisation. The UK Treasury has argued for constructing a firewall between the Fund's surveillance and lending functions – for making the surveillance function independent so that it would not be influenced by the loan officer's familiar tendency to identify with his customer (Balls 2002). The governor of the Bank of England has called for greater independence for management as well as staff as a way of insulating the institution's operations from national self-interest and political short-termism (King 2006). Other European countries, in contrast, have argued for the strengthening of political oversight of staff and management, who have excessive freedom to set and pursue their own agendas. Similarly, European countries are split over the debate on how to simplify the Fund's quota formula, since their voting shares would be differentially affected by quota revision (see below). These contradictory positions leave Europe with less influence than it would otherwise have.

### ***European exchange rate policy***

A second case is intervention in foreign exchange markets<sup>13</sup>. Traditionally, intervention has been arranged on the sidelines of G7 meetings, between finance ministers in consultation with their respective central banks. This reflects the uneasy situation in most G7 countries where central banks are responsible for monetary policy, but finance ministers decide on exchange rate policy, including the need for intervention<sup>14</sup>.

A problem in this context is that there is no euro area finance minister. The president of the Eurogroup does participate in G7 meetings, though his mandate is less than clear. French, German and Italian finance ministers, accustomed to being full partners in G7 meetings, may be reluctant to defer. All this makes it difficult for the euro area to reach agreement with the US, Japan, the UK and Canada on concerted intervention. It makes it difficult to respond with the speed required to meet events in foreign exchange markets. It makes it difficult to coordinate the 'open mouth operations' that go along with intervention. Even among the Europeans, coordination to ensure consistency in public statements on exchange rates is far from perfect. As

Bini Smaghi (2006a) puts it, '[i]n theory only the President of the ECB and the President of the Eurogroup should speak on exchange rate issues. Such discipline has not always been easy to implement.'

A complication is the fact that the ECB plays a larger role in the decision of whether to intervene in foreign exchange markets than other G7 central banks<sup>15</sup>. Finance ministers cannot simply instruct the central bank to intervene<sup>16</sup>. The central bank (more precisely the Eurosystem made up of the ECB and national central banks) must agree, giving it *de facto* veto power. Thus, it is not always clear whether the relevant interlocutor for other countries is the president of the Eurogroup of finance ministers; the president of the EFC, the working party that gathers both finance ministry and central bank officials; or the president of the ECB, who was charged with responsibility for external contacts according to an understanding reached by EU officials at a meeting in Finland in 1999. This last possibility is particularly difficult, insofar as other countries' finance officials preferred to negotiate with elected officials and those responsible to them rather than with appointed central bankers.

These ambiguities significantly complicated efforts to coordinate intervention in foreign exchange markets when the euro fell to 90 US cents in autumn 2000. As described by Henning (2005), it was not clear to other countries whether their interlocutor should be the three euro area finance ministers, the Eurogroup president, the president of the EFC, or the president of the ECB. It was not clear to the foreign partners whether different euro area agents were responsible for deciding intervention, drafting the joint statement on it and issuing it to the press, or how to coordinate negotiations with these separate parties. (In practice, the Europeans agreed that the Eurosystem was 'solely competent' for deciding on intervention, but that the press statement would be negotiated between the central bank, the EFC president, and the Eurogroup president). Efforts to enforce what European participants thought was an international understanding, not only on actual intervention but also on public statements, 'began to unravel almost immediately'<sup>17</sup>. It is indicative of these problems that the second time the Europeans intervened, in November 2000, they did so unilaterally without attempting to coordinate with their G7 partners<sup>18</sup>.

The fact that the president of the Eurogroup now serves for a longer period alleviates these difficulties but does not make them go away. Clean solutions would include transforming the G7 into a G5 where the euro area and the president of the Eurogroup replace France, Germany, Italy and their respective finance ministers. But what is appropriate for finance G7s is less appropriate for G7 meetings concerned with other issues where the euro area is a less relevant entity. The president of the Eurogroup has less influence than finance ministers over national policies, so

that substituting him for the French, German and Italian finance ministers might be seen as reducing European leverage. France, Germany and Italy may resist this change even if there are efficiency arguments in its favour.

Finally, if Europe allows the issue of reconfiguring the G7 to be raised, changes are unlikely to stop with the substitution of the president of the Eurogroup for three finance ministers. Bergsten's (2006) proposal for collapsing the G7 into a G4 made up of the US, China, Japan and the euro area will surely be placed on the table. Other countries with a stake, like the UK and Canada, are less certain to go along.

### ***Global imbalances***

US and Chinese current account balances have widened alarmingly in recent years. The threat to stability posed by a possible disorderly unwinding of these imbalances prompted the IMF to launch in summer 2006 a multilateral consultation process involving China, the euro area, Japan, Saudi Arabia and the United States. The euro area's current account has remained close to balance, suggesting to Europeans that they are not part of the problem<sup>19</sup>. Nonetheless, Europeans are concerned that they may end up bearing a disproportionately large burden of adjustment if the euro ends up rising sharply against the dollar, curtailing exports to the US, without at the same time falling against the renminbi, stimulating offsetting exports to Asia.

Moreover, a sharp fall in the dollar leading to a flight to quality could make it more difficult for central and eastern European countries that are not yet members of the euro area to finance their often-large current account deficits. If they allow their currencies to depreciate in response, they may jeopardise attainment of their goal of euro-area accession. If, on the other hand, they seek to defend their currencies, they may court a financial crisis that would have repercussions elsewhere in Europe (including in the banking systems of the western European countries that have been providing much of the external finance). Clearly, Europe has a stake in the orderly resolution of the problem, with unsustainable imbalances wound down gradually and the dollar adjusting gradually rather than with a crash.

Putting external balances on a sustainable footing will require policy changes by all the major players, including adjustments to produce higher public and private saving rates in the US, and a greater reliance on domestic demand in Asia. In particular, changes in China's exchange rate regime to allow greater appreciation of the renminbi will almost certainly play a role in reducing China's enormous current account surplus. Here European countries have sent mixed messages. Moreover, while it remains underrepresented at the IMF, China will be reluctant to engage constructively in the

Fund's multilateral consultations process. China's IMF underrepresentation is the flipside of Europe's overrepresentation, as we have shown. Thus, reform of European representation seems a necessary condition if talks on global imbalances are to have a chance of success.

## **A proposal**

How might the situation be rationalised? In this section we argue that it is desirable to consolidate European representation in international organisations and groupings, from the IMF and World Bank to the G7, G10, G20 and Financial Stability Forum, in a smaller number of chairs. In the Bretton Woods institutions, one can imagine existing quotas and votes being grouped under two chairs initially, one for the euro area and one for other EU countries (as in Bini Smaghi 2004). Ultimately these two chairs might be consolidated into one. The EU could become a single member of the IMF and the World Bank, with quota formula applied to it formally as if it were a single economy. In groups like the G7 and G10, it again makes sense for European countries to have a unified representation or at most two representatives for a transitional period, one for the euro area and one for other EU countries.

Such reform is desirable both for Europe and the rest of the world. For Europe, the preference heterogeneity and difference in outlooks that impede movement toward a single European foreign policy are more limited in the case of foreign monetary and financial policies than other foreign policy issues. To be sure, there remains heterogeneity of preferences – between, say, Ireland and Italy about the stance of ECB policy, reflecting different degrees of dynamism of their economies – but this has not prevented 13 European countries to date from moving to a single monetary and exchange rate policy, indicating their perception that the advantages of scale economies in provision dominate.

Consolidating Europe's representation would also enhance the continent's influence. Voting as a group, the EU or even the euro area would have the single largest block of votes in the IMF and World Bank. A single EU chair would not need the support of many other members to form a winning coalition. Bini Smaghi (2006b) and Leech and Leech (2005) calculate that it would become a critical swing voter in these organisations. In the G7, the G10, and the G20, the euro area or, even more, the EU would represent an economic area as large as the United States and larger than Japan and other members, whether measured in terms of production, trade or financial flows, giving its arguments weight and giving the member states more leverage over outcomes.

Consolidating Europe's representation is also in the interest of the rest of the world insofar as doing so frees up seats for underrepresented emerging markets. The G7 and G10 are poorly configured for addressing a range of important economic and financial issues because systemically significant emerging markets – China most prominently – are not represented. While replacing the G7/10 with the G20 has the advantage of including such systemically significant emerging markets, 20 is too large a number for efficient negotiation<sup>20</sup>. (In a way, the G20 epitomises the irrationality of Europe's present representation, in that it includes the four European G7 members – France, Germany, Italy and the UK – but also the European Union). What is needed is a smaller body, for example a G4 made up of the US, Europe, Japan and China (Bergsten 2006) or a G4 plus, composed of these four entities with a rotating cast of additional characters, depending on issue (Kenen 2005).

Similarly, consolidating European representation at the IMF and World Bank into a smaller number of chairs would make it possible to provide more chairs at the Board table for emerging markets while not increasing the size of the Board, where the latter is to be avoided for efficiency reasons. While discussion at the September 2006 annual meetings of the IMF and World Bank focused on changes in quotas and voting shares (see below), there also was a recognition that giving emerging markets more voice in these institutions, and thereby enhancing the legitimacy of their operations, will require giving them more seats on their Executive Boards. With European countries (including two non-EU members: Norway and Switzerland) occupying as many as nine out of 24 seats on those Boards, freeing up chairs for other countries would require some European members to give up theirs. The reluctance of smaller European countries to volunteer is increasingly seen as an obstacle to progress.

Europe also plays a key role in the redistribution of voting shares in the Bretton Woods institutions. There was agreement at the IMF-World Bank meetings in September 2006 on an *ad hoc* increase in quotas for four underrepresented emerging markets (China, Turkey, Mexico and South Korea), amounting to an aggregate increase in IMF quotas of 1.8 percent, with a promise of more comprehensive quota reform to follow by 2008. It is no coincidence that the US has been a proponent of quota revision, since its current voting share is, in fact, less than implied by current quotas<sup>21</sup>. In contrast, many European countries, especially a number of smaller ones, tend to be overrepresented. The more comprehensive reform will utilise an updated quota formula, presumably based on some combination of country size, openness, and balance-of-payments variability. But the IMF Board has decreed that the quota formula should be simplified in the interest of transparency, which presumably means an even heavier weight on GDP and less on

ancillary variables. The representation of smaller EU countries will be further reduced if the revised quota formula reduces the weight attached to the export ratio<sup>22</sup>. Thus, it is not surprising that they are more sceptical about more comprehensive quota reform. But without European support or at least acquiescence, it will not be possible to marshal the 85 percent support needed to push through quota revision.

Clearly, there is intense pressure for reform of country representation at the Bretton Woods institutions and in the world's other economic steering committees. Europe's numerical overrepresentation is unsustainable. The alternative to reducing Europe's chairs and shares, at the same time consolidating European representation in order not to lose influence, is for the international organisations and groupings to which European governments attach importance to continue to lose legitimacy and influence. Asian countries would set about multilateralising the Chiang Mai Initiative and strengthening regional surveillance mechanisms as steps toward creating an alternative to the IMF. They would likely continue to accumulate foreign exchange reserves at a rapid pace in order to protect themselves from having to borrow from the Fund again. European countries would find themselves blamed for blocking meaningful governance reform and further weakening the legitimacy and influence of the multilateral financial institutions, or else they would have to agree to having their shares and chairs reduced without accompanying changes that work to maintain their influence.

### ***Incrementalism as learning by doing***

If these arguments are compelling, then why is there such reluctance to move in this direction? Some European countries may fear that consolidated representation will end up forcing them into positions inconsistent with their national interest. They may worry that Europe lacks the infrastructure and experience to carve out common positions and that its influence in these venues will be reduced.

A logical way of alleviating these concerns is to move forward incrementally, in one venue. If experience in one organisation reassures the member states that they will not be forced into uncomfortable positions, that arrangements for reaching such decisions are adequate, and that reform in this area does not mean that member states' competences in other areas related to foreign policy will inevitably be infringed upon, then there may develop a greater willingness to consolidate European representation in other monetary and financial groupings.

As noted above, this incremental approach can be justified in terms of the literature

on gradual policy reform in transition economies, where it is argued that experience with limited reform may help to convince otherwise sceptical stakeholders of the positive effects of more broad-based reform (Dewatripont and Roland 1992). If it is necessary to compensate losers (a country like Belgium that stands to lose its chair in both the IMF and the World Bank, as well as the profile it enjoys by virtue of the importance of the G10, of which it is a member), then the cost of compensatory concessions in other issue areas will be more limited (given that Belgium would be losing only one of these three prerequisites at a point in time); this may in turn make such concessions easier to extend for the winners. If the EU follows through on its promise to compensate Belgium with concessions in other issue areas, then its commitment to make compensatory side payments in return for agreement on further consolidation will become more credible.

The objection to incrementalism in the context of transition was that structural reforms are interdependent – that one reform will have positive effects only if it is adopted simultaneously with others. This is less obviously true of reform of European representation in the Bretton Woods institutions and the world economy's other steering committees. Admittedly, the fact that the World Bank and IMF work together, through *inter alia* their Development Committee, debt reduction initiatives and financial stability reviews, means that reform of European representation in one of these organisations without accompanying reform in the other would create complications. But this general argument, that reforms in different areas are strongly complementary, clearly holds less water in the case of governance reform.

### ***The IMF as the place to start***

The logical place to start is with European representation at the IMF. It is not clear that different European countries have very different preferences regarding country surveillance, multilateral surveillance, and emergency lending, the IMF's three core activities. The major European countries are unlikely to have to resort to the IMF for financial assistance. To be sure, individual member states may have different attitudes regarding assistance for non-EU countries insofar as there are differential implications for their residents. Thus, Spain and Italy were more sympathetic to arguments for an international rescue package for Argentina in the summer of 2001 because their banks and households had high levels of exposure there. But it is not clear that this heterogeneity of exposures with respect to external financial conditions is any greater than heterogeneity in domestic exposures (some European banking systems are more exposed than others to, *inter alia*, European housing markets), and this has not hindered the adoption or pursuit of a common monetary policy by around half the members of the European Union<sup>23</sup>. As Europe develops a

more integrated financial market with pan-European banks whose shares are held by residents of all European countries, and not just residents of the country where the bank was founded, national differences will figure even less in this calculus.

The same point applies to the IMF's multilateral surveillance and consultations over issues like global imbalances. Insofar as members of the euro area are concerned about a disorderly correction of global imbalances, they will be affected through the same channel, namely, appreciation of their common exchange rate against the dollar. They thus have a common interest in preventing the euro from appreciating excessively. That the members of the euro area have this shared interest has already been acknowledged by the IMF, in that it has invited the euro area, and not individual European states, to participate in its first multilateral consultation on the issue of global imbalances. To be sure, European countries differ in their dependence on the US and Chinese export markets (see Table 5.2), but these differences are not pronounced enough seriously to hinder the adoption of a common policy stance.

Indeed, the very existence of the euro provides a rationale for consolidating euro area representation in the Fund that does not also carry over to the World Bank, the G7 or the G10. The IMF is fundamentally concerned with the management of balance-of-payments problems, something that cannot exist within a single currency area. Historically it has focused on exchange rates, and the euro area has only one exchange rate vis-à-vis each extra-euro-area country. IMF quotas are traditionally set using formulas that attach weights to a member's external trade and payments, and

*Table 5.2: Euro area trade with China and the US\* (percent of GDP)*

|             | Exports to |      |      |      | Imports from |      |      |      |
|-------------|------------|------|------|------|--------------|------|------|------|
|             | China      |      | US   |      | China        |      | US   |      |
|             | 1998       | 2005 | 1998 | 2005 | 1998         | 2005 | 1998 | 2005 |
| Austria     | 0.3        | 0.8  | 1.2  | 2.4  | 0.4          | 0.9  | 1.1  | 0.9  |
| Belgium     | 0.7        | 1.4  | 3.5  | 5.4  | 1.1          | 3.6  | 4.9  | 4.4  |
| Germany     | 0.5        | 1.1  | 2.3  | 3.1  | 0.6          | 1.6  | 1.4  | 1.4  |
| Spain       | 0.2        | 0.2  | 0.8  | 0.7  | 0.5          | 1.1  | 1.1  | 0.7  |
| Finland     | 1.4        | 1.2  | 2.5  | 2.1  | 0.5          | 1.3  | 1.6  | 1.1  |
| France      | 0.5        | 0.5  | 1.7  | 1.6  | 0.4          | 0.9  | 1.6  | 1.2  |
| Greece      | 0.1        | 0.1  | 0.4  | 0.4  | 0.5          | 1.0  | 1.1  | 0.8  |
| Ireland     | 0.5        | 1.0  | 9.7  | 10.3 | 0.8          | 1.1  | 7.9  | 4.7  |
| Italy       | 0.4        | 0.5  | 1.7  | 1.7  | 0.4          | 1.0  | 0.9  | 0.8  |
| Netherlands | 0.4        | 0.7  | 2.0  | 2.8  | 1.9          | 5.6  | 4.7  | 4.5  |
| Portugal    | 0.1        | 0.2  | 1.0  | 1.1  | 0.3          | 0.4  | 0.9  | 0.7  |

\* Source: Ahearn and von Hagen (2006). Data for Slovenia are not included.

the advent of the euro suggests removing intra-euro-area trade and payments from these calculations.

In addition, the infrastructure for reaching joint positions is relatively well advanced. As described above, SCIMF prepares the work of the EFC on the IMF and related issues. Documents agreed by SCIMF and endorsed by the EFC are then passed to European EDs with the intent of defining a common position. There is also the EURIMF, the grouping of European representatives, which seeks to coordinate European greys, and the EU presidency grey mechanism in which European EDs attempt to reach agreement on support for the EU presidency grey. These arrangements can provide a springboard for further moves in this direction.

Finally, the swing-voter analysis of Bini-Smaghi (2006b) and Leech and Leech (2005) suggests that Europe can reduce its voting share without weakening its influence if it at the same time undertakes reforms that allow it to vote as a bloc.

If the advantages of a unified position are so pronounced, why are European countries not more open to the idea? One factor here is mixed constituencies (see Table 5.3). A number of the constituencies headed by European countries include also other countries with very different characteristics and preferences. European countries in such constituencies (Belgium, Netherlands, Spain, Italy, Ireland, Denmark, Finland, Sweden and the Baltic states) must temper their positions in order to reach common ground with non-European and non-EU members. This is less of a problem than it once was, insofar as eastward expansion has brought all members of the Nordic-Baltic constituency except for Iceland into the EU. The constituency of which Belgium is the largest member includes ten countries, only three of which (Belarus, Khazakstan and Turkey) are not EU members. In the constituency of which Italy is the largest member, only Albania, San Marino and Timor-Leste are not EU members, and it might be argued that this trio is too small to affect much the position of their director. But Poland and Spain are both in constituencies with seven non-EU members. The Netherlands and Cyprus are in a constituency with 10 non-EU members. Ireland is in a constituency with 11 non-EU members. Clearly, these countries may find it difficult to subscribe to a common EU position.

Another factor is that the IMF Articles of Agreement make no provision for admitting the euro area or the European Union as IMF members; they recognise only individual countries. But if the Articles of Agreement are an obstacle to sensible action, then they can be changed. The Articles have in fact been amended repeatedly in the past. If amendment is difficult, then the Articles can be interpreted flexibly, as was the case when Egypt and Syria sought to form the United Arab Republic in the

Table 5.3: IMF constituencies\*

| United States  | Japan  | <b>Germany</b>   | <b>France</b>   |
|--|--|--|---|
| United Kingdom   | <b>Austria</b> , Belarus, <b>Belgium</b> , Czech Republic, Hungary, Kazakhstan, <b>Luxembourg</b> , Slovak Republic, <b>Slovenia</b> , Turkey                      | Armenia, Bosnia Herzegovina, Bulgaria, Croatia, Cyprus, Georgia, Israel, Macedonia, Moldova, <b>Netherlands</b> , Romania, Ukraine | Costa Rica, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, <b>Spain</b> , Venezuela   |
| Albania, <b>Greece</b> , <b>Italy</b> , Malta, <b>Portugal</b> , San Marino, Timor-Leste   | Australia, Kiribati, Korea, Marshall Islands, Micronesia, Mongolia, New Zealand, Palau, Papua New Guinea, Philippines, Samoa, Seychelles, Solomon Islands, Vanuatu | China  | Antigua and Barbuda, The Bahamas, Barbados, Belize, Canada, Dominica, Grenada, <b>Ireland</b> , Jamaica, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines   |
| Denmark<br>Estonia<br><b>Finland</b><br>Iceland<br>Latvia<br>Lithuania<br>Norway<br>Sweden   | Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libyan Arab J. Maldives, Oman, Qatar, Syrian Arab Rep., U.A. Emirates, Yemen, Rep. of                               | Saudi Arabia   | Brunei Darussalam, Cambodia, Fiji, Indonesia, Lao People's Dem. Rep., Malaysia, Myanmar, Nepal, Singapore, Thailand, Tonga, Vietnam   |
| Angola, Botswana, Burundi, Eritrea, Ethiopia, Gambia, Kenya, Lesotho, Malawi, Mozambique, Namibia, Nigeria, Sierra Leone, South Africa, Sudan, Swaziland, Tanzania, Uganda, Zambia | Azerbaijan, Kyrgyz Rep., Poland, Rep. of Serbia, Switzerland, Tajikistan, Turkmenistan, Uzbekistan   | Russian Federation   | Afghanistan, Algeria, Ghana, Iran, Morocco, Pakistan, Tunisia   |
| Brazil, Colombia, Dominican Rep., Ecuador, Guyana, Haiti, Panama, Suriname, Trinidad & Tobago  | Bangladesh<br>Bhutan<br>India<br>Sri Lanka   | Argentina<br>Bolivia<br>Chile<br>Paraguay<br>Peru<br>Uruguay   | Benin, Burkina Faso, Cameroon, Cape Verde, Cen. African Rep., Chad, Comoros, Congo, Dem. Rep., Congo, Rep., Côte d'Ivoire, Djibouti, Equatorial Guinea, Gabon, Guinea, Guinea-Bissau, Madagascar, Mali, Mauritania, Mauritius, Niger, Rwanda, São Tomé Príncipe Senegal, Togo |

\*Euro area countries in bold

1950s. Finally, it is not clear that meaningful reform requires recognising the euro area or the European Union as an IMF member. It might simply be possible to reorganise constituencies so that the members of the euro area are all members of one constituency, which is then free to elect or choose its own chair, while other EU member states are members of a second constituency with the same prerogative. The members of these two constituencies could ultimately be consolidated into one constituency, if the members so chose, without requiring a change in this provision of the Articles of Agreement.

Another variation on this theme would be to reorganise Europe not into two constituencies but into six or seven. Truman (2005) has previously suggested that the consolidation of European representation might be done in stages so as not to overreach the development of political will. A first step would be to transfer EU members (Poland, Spain, Ireland) not presently in EU-headed constituencies to EU-headed constituencies. The second step would then be to transfer non-EU countries (Kazakhstan, Timor-Leste, Armenia, Bosnia, Croatia, Georgia, Israel, Macedonia, Moldova, Ukraine) to other non-EU headed constituencies. Later the EU-headed constituencies could be consolidated. This would be a more modest variation on our proposal<sup>24</sup>. It would also be consistent with the strategy of learning by doing through incremental reform.

### ***The positions of the members***

Although Bini Smaghi (2006b) and Leech and Leech (2005) suggest that the members of the euro area, were they to form a coalition, would become critical swing voters in the IMF, individual member states might lose voice or voting power as a result of forming such a coalition. Smaller euro area countries that currently possess a seat at the Board table would be concerned about losing voice, since they would not have the same capacity to contribute to the formulation of a consensus among directors on important policy questions<sup>25</sup>. They would be compensated, however, because the single European representative would be even more influential in the development of that consensus, insofar as voice is correlated with the number of votes possessed by his/her constituency.

They could be further compensated by adopting internal voting rules giving heavier weights to smaller countries for deciding the positions of the European director. In an extreme case, one can imagine a process whereby all members are weighted equally – one country, one vote as in the Executive Board of the ECB. Naturally this is unlikely to be congenial to large European countries accustomed to having more votes in the Fund than their smaller neighbours. In fact, Leech and Leech (2005)

show that all EU countries would gain voting power in the Fund if the constituency's position is determined by simple majority voting using current IMF weights and on the basis that the single European chair would have the same voting power as the US<sup>26</sup>. Even here, individual EU members would see their effective voting power strengthened, compensating them in part for giving up their separate seats at the Board table<sup>27</sup>.

Given this, what are the prospects for reform? The European Parliament seems favourably inclined, adopting in March 2006 a resolution on the strategic review of the IMF. This called on member states 'to work towards a single voting constituency – possibly starting as a euro constituency, with a view, in the longer term, to securing consistent European representation, involving the Ecofin Council presidency and the Commission, subject to the European Parliament's scrutiny.'

Ultimately, however, the prospects for reform depend on the attitudes of the member states. Italy has probably been the most strongly supportive of coordination in the Bretton Woods institutions. Phillips (2006b) suggests that it may be inclined toward more centralised European representation because it is already in a constituency with Portugal, Greece and Malta and therefore has some experience with cooperative decision making<sup>28</sup>.

France and Germany, traditionally the motors of European integration, have been sympathetic in the past. Phillips (2006b, p.19) reports that both countries 'have previously stated a willingness to consider single European representation or a combined seat in the [Bretton Woods institutions], although these proposals were perhaps made because they were inherently unlikely to be implemented (and in the context of enhancing Franco-German friendship rather than in the context of genuine commitment to global governance reform).' In 1998 the French Finance Minister, Dominique Strauss-Kahn, publicly floated the idea of a Franco-German chair at the IMF<sup>29</sup>. In 2003 the German Development Ministry proposed a double-majority voting system for the Bretton Woods institutions, which would give more voice to populous developing countries (German Ministry for Economic Cooperation and Development 2003). A Franco-German contribution to the European Convention, from 22 December 2002, stated that: 'With respect to the external representation of the euro area, France and Germany share the view that a single representation in IFIs such as the IMF will be the adequate voice of an integrated Europe' (cited in Eurodad 2006, p.21).

More recently, positions appear to have hardened. German Bundesbank President Axel Weber recently urged caution about IMF reform, saying: 'A broad package has to

be found for a more transparent and fair representation of all IMF members. To that end, European Union countries should not prematurely relinquish their own justified positions and claims' (EurActiv 2006). Germany's seemingly dimmer view of the notion of a unified European seat brings the German position more in line with the results of the voting power analysis above, and may also reflect some recent ebbing of enthusiasm for closer European integration. Following the IMF/World Bank annual meetings in September 2006, German's Ministry of Finance included Germany in the set of countries that are underrepresented in the IMF (Steinbrück 2006). German Finance Minister Peer Steinbrück told reporters in Singapore that as the world's third-largest economy – after the US and Japan – Germany deserved to keep its influence in the IMF (Deutsche Welle 2006). He balked at US suggestions that the size of a country's GDP should be given a predominant role as part of the planned overhaul<sup>30</sup>. Germany was similarly behind the statement prepared by European Union members for the G20 meeting in Sydney in October 2006. This argued that any redistribution of voting rights within the Fund should favour only 'the most underrepresented members' and warned that 'it would be premature to press for changes in the size and composition of the executive board'<sup>31</sup>.

The UK's position is likely to be similarly sceptical, since the country has reservations about anything that smacks of euro-federalism. But the UK Treasury and Bank of England have been outspoken about the need for IMF reform, and this makes it difficult for the country now to obstruct other EU countries' efforts to consolidate their representation. Moreover, the precedent of monetary union suggests that the British government will not stand in the way if other EU member states wish to go ahead. This suggests that, initially, consolidation will take the form of the members of the euro area joining together in a single chair.

But these observations also suggest that consolidating under a second chair representation of the UK, Sweden, Denmark and those central and eastern European member states that have not adopted the euro may be less feasible in the short run. Even were the UK to be made the permanent representative on the board of that constituency, it would be unlikely to welcome a switch from exclusive representation to a constituency in which it would have to reach common positions with other members, at least in the short run. This suggests that the first step, a single chair for the members of the euro area, is likely to come more quickly than the second step, a single chair for other EU members. Again, however, there is no reason why Europe might not move incrementally.

## Conclusion

Europe's fragmented representation in the arenas where international monetary and financial policy is made causes it to punch below its weight. Although the US is no bigger than Europe, it has been able to exert more influence in the operation of the Bretton Woods institutions, and the other venues where these issues are discussed, precisely because it speaks with one voice. Europe's numerical overrepresentation on the boards of the International Monetary Fund and World Bank and in the G7 and G10 is also seen as undermining the legitimacy of these organisations. Europe's reluctance to cede seats on these global steering committees causes it increasingly to be regarded as an obstacle to fundamental governance reform. The ultimate result of this reluctance may be that Europe will be amply represented on a set of irrelevant committees, as emerging markets use their international reserves to set up regional rivals to the IMF and World Bank and the US substitutes bilateral consultations with China for the G7 process. Together these observations constitute a compelling argument for unifying Europe's representation so that chairs can be freed up for underrepresented emerging markets, enhancing the legitimacy of existing global institutions, but without diminishing – and, indeed, with the possibility of enhancing – Europe's influence over their operation.

But the obstacles to progress in this respect remain formidable. The difficulties of EU member states in attempting to define a single foreign policy carry over to foreign monetary and financial policies. Member states with different views of monetary and financial issues are not convinced that their positions would be more effectively advanced by a single European representative. Smaller member states that have inherited privileged positions resist calls for self-sacrifice. They are reluctant to give up what remains their most visible link to their historical status as global powers. But this dilemma is artificial; to repeat, if EU members do not give up their excessive numerical representation in the institutions of global monetary and financial governance, those institutions will fall by the wayside.

This lends urgency to the efforts to reorganise Europe's representation in these arenas. We have suggested an incremental strategy. Start with the IMF, where preferences are relatively homogeneous, and the infrastructure conducive to the harmonisation of member states' positions is relatively well developed. If the member states discover, as we expect, that their influence is strengthened without forcing them significantly to compromise their views, then it will be possible similarly to move forward in other international organisations and groupings. The strategy may be risky, but the alternative is less pleasant to contemplate.

## Notes

- 1 For helpful comments we thank our discussant, Thomas Wieser, and other participants at the conference on Europe and the Global Economy, Brussels, 12-13 October 2006.
- 2 In this chapter, we focus on the EU's monetary and financial relations with the rest of the world rather than its economic relations generally, or its trade policies in particular, since EU trade policy is organised very differently, this competence long ago having been given to the European Commission.
- 3 See Tables 5.1 and 5.3 for membership of selected international forums, and for International Monetary Fund constituencies.
- 4 Like Sweden, Denmark, and 11 of the 12 new EU member states at this stage.
- 5 See for example Mahieu, Ooms and Rottier (2003), who argue that the EU member states would be prepared to become a full-fledged single member of the IMF only if they were willing to assign to the Union responsibility for a common foreign policy.
- 6 We will describe below how the monetary and financial issues that are the subject of this chapter were treated at the convention.
- 7 The 180 plus members of the International Monetary Fund and the World Bank are organised into 24 constituencies or groups of countries, each of which is represented by one member on the institution's Executive Board.
- 8 See eg Phillips (2006a).
- 9 There are other arguments as well, as we detail in the fourth section of this chapter, notably that the underrepresentation of Asian countries on the Executive Board, which is increasingly viewed as the mirror image of Europe's overrepresentation, poses a challenge to the legitimacy of the institution. In other words, the rationalisation of European representation that has as a byproduct the freeing up of additional chairs for other regions would lessen the pressure for Asian countries, in particular, to set up a rival regional arrangement on the basis of the Chiang Mai Initiative, weakening the existing multilateral framework.
- 10 In practice, things are even more complicated. For example, officials of the European Commission have dealt directly with the heads of the World Bank and the IMF, without the intermediation of the Council, to discuss issues such as international financial assistance to the Balkans. The Commission is a member of the Financial Action Task Force on countering money laundering along with most EU member states (Truman 2004). On these international economic issues, the Commission and not the Council appears to take the lead role.
- 11 Bini-Smaghi (2004) argues that this is made possible by the fact that European countries share common views on matters of multilateral surveillance of the major economies and the world economy. But it can also be argued that the EURIMF's president's speech is weak soup because it cannot contain anything objectionable to any of the EU countries represented on the Board. Again, this is indicative of the limits of soft coordination.
- 12 Dolan and Bull (2006).
- 13 A previous analysis of this case, on which we rely here, is Henning (2006).
- 14 'Uneasy' because only if sterilised intervention is effective, on the grounds that domestic and foreign bonds are imperfect substitutes for one another, is it possible for finance ministers to attempt to move the exchange rate without getting a concession from the central bank to alter monetary policy. The literature on the effectiveness of sterilised intervention is large. See *inter alia* Dominguez and Frankel (1993).
- 15 Generally speaking, 'the ECB decides on and carries out operations in the foreign exchange market. The overall framework in which exchange rate policy is conducted is the competence of the Eurogroup, in consultation with the ECB' (Bini Smaghi 2006a). The way that responsibilities for

- exchange rate policy are shared among the different European institutions is set out in Article 111(1) of the EU Treaty.
- 16 As Henning (2006, p.12) puts it, European finance ministers decided that 'it would not be appropriate to attempt to force or instruct the Eurosystem to intervene.'
  - 17 Henning (2006), p.24.
  - 18 Although the decision to proceed unilaterally may have also reflected the approach of the US presidential elections, which left that country's treasury preoccupied by other matters.
  - 19 Ahearne and von Hagen (2006) and Lane and Milesi-Ferretti (2006) offer European perspectives on global imbalances.
  - 20 Some will observe that there are 24 members of the Executive Boards of the International Monetary Fund and World Bank, as mentioned elsewhere, but this is a much more heavily institutionalised context. Directors meet three times a week throughout the year, which enables them to routinise their procedures to a much greater extent than G7 principals and deputies. In any case, a number of authors (eg Truman 2005) argue that the IMF Executive Board could be usefully streamlined by reducing its size.
  - 21 The US has, in fact, committed to not asking for an increase in its share in the course of the current quota revision process.
  - 22 It would of course be further reduced if intra-EU transactions were not included in this calculation, which of course is not likely in the absence of more far-reaching reform.
  - 23 It can also be argued that there exists similar heterogeneity within the US, but that this has not prevented the country from agreeing on a policy toward the IMF. Recall the conflicts between large money centre banks and smaller banks in the interior of the country over developing country debt (and the difficult of getting the latter to participate in the Baker Plan). Or recall Paul O'Neill's criticism of the IMF in 2001 that it was squandering the hard-earned savings of American plumbers and carpenters. This again alludes to the fact that not all segments of US society felt the same way about the merits of emergency lending.
  - 24 It is sometimes argued that reorganising the constituency situation so that EU members were represented in exclusively EU constituencies might also have a downside. The increasing politicisation of the International Monetary Fund partly reflects the division of the institution into lending and borrowing countries (Rajan 2006, Mahieu, Ooms and Rottier 2003). Mixed European constituencies have provided at least one counterweight to this. That moderating influence would be weakened by the move to a single European chair. We are not entirely convinced by this argument. Which countries are borrowers and lenders in the Fund is not set in stone – Asian countries that have borrowed in the past but are now flush with reserves are considerably less likely to borrow in the future, for example – making the design of the constituency system less than ideal for addressing this polarisation. Others like Kenen *et al.* (2005) and King (2006) have suggested alternatives for addressing this problem.
  - 25 Thus, for example, the Dutch have been vocal opponents of any reorganisation of the IMF Board that might result in their losing their existing chair. See Zalm (2006).
  - 26 A not unreasonable assumption in view of the quota formula and balance of power within the Fund.
  - 27 This is less likely if the EU position is decided by the double-majority voting procedure of the Nice Treaty, which would require the agreement of a substantial supermajority before the European chair could take a position. In this case the EU would be unable to act as the decisive swing voter on many issues (where the requisite supermajority was absent).
  - 28 But the country has not always been consistent here: Italy encouraged Timor Leste to join its constituency in 2002, in a step away from exclusive European representation.
  - 29 Corrales-Diez (2003) reports that the French government has also supported the concept of a single chair, at least in principle.

30 Also in Singapore, the Netherlands expressed reservations about the complex plan on the opposite grounds that it would see its voting power diluted. The formula needed to be improved and could not be prejudged, Dutch Finance Minister Gerrit Zalm said.

31 Both quotes are from Swann and Louis (2006).