The Reform of International Financial System and China’s Policy Options

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Abstract: The reform of international financial system is focused on the following aspects: international monetary system, international financial institutions (IFIs), and international financial regulatory system. The US, European Union, Japan, and the Emerging Market Countries all have different stances concerning the reforms in these fields. Specifically speaking, the differences between the US and EU have become greater than before. There is also an obvious deviation in the interests and demands of Emerging Powers and the US and EU. In addition, the G20 has become the major forum for economic coordination among major powers, which also demonstrates that the reform of international financial system has entered into the critical period. There has been an issue of important strategic meaning for China, that is, how to grab the historic opportunity and take appropriate actions to participate and advance the reform of international financial system. In our view, China’s strategic thinking in addressing this reform should include the following aspects: to aim at the strategic breaking point, locate the strategic supporting factors, strive for strategic cooperation among the major powers, grab the historic opportunity, and advance the reforming process when time is ripe.

After the eruption of the current global financial crisis, the reform of international financial system became the focus of both the governments and academic community around the world. Bearing in mind their respective significant interests and concerns, the major powers coordinated their interests with an unprecedented frequency. There also existed intense strategic competition and cooperation among the major powers. Under this circumstance, China needs to present its own strategic arguments on the coming reform of international financial system, so as to better vindicate China’s core interests and reflect the stance and demands of developing countries.

Major Challenges to International Financial System

The international financial system in this article has a broad meaning, including what we ordinarily distinguished as international monetary system and international financial system in the narrow sense. International financial system was formed on the basis of coordinating the monetary institution, legal institution, and economic institution from various countries in the world. It reflects the international monetary relations and constitutes the general framework of international financial activities, including the activities of major IFIs, central banks of major economies, and some giant financial enterprises with systematic importance. The modern international financial system experienced three development stages. The first stage started from the year 1816 to the end of World War I, which is called the period of gold standard. The second stage was the Bretton Wood System, ranging from 1945 to the middle years of 1970s. The third stage was the so-called Jamaica System, starting from the Jamaica Agreement of 1976. The breaking out and spread of the current financial crisis has led to great concerns of the international community over the reform of international financial system, since the crisis has reflected the defects and deficiencies deeply rooted in the system. Generally speaking, the major issues related to the reform are the position and future of the US dollar in the international monetary system, the reform of the IMF and other major IFIs, the impact of sustaining global economic imbalance and correction approach, and also the problems existing in the international financial regulatory system. We will mainly discuss the former three issues in the following discussions.

1. Leaders and Stabilizers in international financial system

The proponents of Hegemonic Stability Theory argue for a hegemonic system of international economy, which they regard as more stable and suitable. Hegemonic power can impose some disciplinary restraints on international financial system and harness its ability as international lender of last resort. This argument implies the recognition of existence of a powerful central agency, which means that the performance of the global or regional system depends on the policy changes of this critical agency, just like the dependence of national economy on the work of its central bank. [1] In practice, the focus of this theory is often related to the role of the United States. Just as what Robert Gilpin had pointed out, since the end of the Cold War, economic cooperation among the United States and its allies has eroded considerably, and American foreign and economic policy has become more unilateral and self-centered. [2] Actually speaking, since President Nixon made the declaration on the disentanglement of US Dollar with the Gold, the United States has been evading its responsibility to stabilize international monetary system. Contrarily, it always abuses the supremacy of the US Dollar as international key currency so as to maintain its enduring "twin deficits" of current account and fiscal budget. In the meantime, due to post-World War recovery of world economy, and what's more important, the emergence of emerging market economies after the Cold War, the relative economic power of the US in the international financial system has declined on a large scale compared with the time when the Bretton Woods System was established. The current financial crisis just makes this power decline more outstanding. The US has lost the ability of maintaining the stability and development of international economic system by itself alone. In conclusion, the stabilizing force of post-Bretton Woods System may be more reliable on the coordination of major economic powers, as well as the development of international regime dominated by these economic powers.

2. Debates on the IMF Reform

In Robert Triffin's view, the internationalization of foreign currency reserve under the auspice of IMF was the most logical solution to the above-mentioned problem. The IMF could have less difficulty in adjusting its credit business after internationalization, which would make it match the expanding legitimate demand for satisfaction in the world economy. This would also be conducive to the stabilization of international monetary system. At the same time, he also commended the complementary role played by regional monetary systems. In his view, closer regional agreement was a useful supplement and support for relatively looser agreement reached on the global scope, as well as paving the way for participating states to complete the union of economic sovereignty under amicable circumstances.[3] As for the role of IMF as International Lender of Last Resort, the risk of moral hazard is an issue of much concern. In some scholars' view, there may be three types of moral hazard deriving from IMF's actions. The first is the loss of incentive for developing countries to implement preventive policy. The second kind derives from the hopes of international

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[1] John Smithin, *Controversies in Monetary Economics: Ideas, Issues and Policy,* (revised edition), Chinese edition, Shanghai Financial and Economic Publishing House, 2004, pp.138-139.

[2] Robert Gilpin, *The Challenge Of Global Capitalism: The World Economy In The 21st Century*, Princeton University Press, 2000, p.11.

[3] Robert Triffin, *Gold and the Dollar Crisis: The Future of Convertibility*, The Commercial Press, 1997, pp.152-153.

creditors to seek protection after financial crisis. The third type emerges from the anticipation of banks and private companies doing risky business to be bailed out from their foreign debts, in this way making the debt socialized domestically.[4]

However, the debate on the IMF is more and more concerned with its effectiveness and legitimacy. The lack of effectiveness was manifested in the gap between the limited resources at its disposal and the huge amount of funds needed by so many countries facing balance of payment crisis. The lack of legitimacy was even more often blamed by a large number of developing countries. The governance structure provides the developed countries with dominating status in the IMF. The blame has also often been put on the conditionality of IMF loans, which always imposes tight macroeconomic policy options on the debt countries regardless of the real cause of financial turmoil existing in those countries. It's always doubted that the IMF had become an instrument for the US or European countries to achieve their own national policy goals. In the annual meeting of IMF of 2006, all the members reached consensus to the resolution on the reform of voting rights. In addition to the decision of increasing the voting shares of China and other three countries with the serious degree of underestimation, the meeting also decided to start the second-phase plan of packaged reform in two years. This reform of its voting structure constitutes an important part of the whole structural reform of the IMF. The resolution on this reform also emphasized that the representativeness of low-income countries and most developing countries in the entire IMF should not be impaired.[5] The G20 Pittsburgh Summit has also proposed a 5 percent transfer of voting shares from the developed countries to emerging countries and developing countries. In 2010, the IMF will complete its overhaul of the existing governance structure, which may lead to a dramatic change of power distribution in the IMF.

3. Global Imbalances and Development of International Economic Coordination

In recent G20 Pittsburgh Summit, considering that the US economy is slowly getting out of the risk of depression, President Obama reiterated the topic having been intensely debated two or three years ago, the rebalance of world economy. Global economic imbalances have been a major issue threatening the stability of world economy. Before the year of 1997, world economy was basically balanced, with a relatively moderate American current account deficit. However, imbalances existed in global economy since 1998, with rapidly increased global imbalances since the year of 2004. The major problem lies in that, with almost all the global current account deficit borne by the United States alone, global current account surplus also mainly concentrated on East Asian Economies, increasing rapidly in China and other East Asian economies excluding Japan (including Four Asian Tigers, Indonesia, Malaysia, Thailand, and Philippines).[6] The continuing existence of this situation of unbalancing is bound to cause great impact on world economy, and especially the international exchange rates system, with the stability of the latter having always been one of the major goals of international economic coordination. In order to prevent the imbalances from turning into a chaotic readjustment of world economy, the IMF presented a mid-term strategy to promote orderly adjustment of global imbalances in 2004. In April 2006, IMF Managing Director Rato suggested to hold multilateral consultation on global imbalances as an implementing measure of mid-term strategy. The United States, Japan, the euro area, Saudi Arabia,

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[4] World Bank, *Global Economic Outlook and Developing Countries: 1998/1999, after the Economic Crisis,* Chinese edition, Chinese Financial and Economic Publishing House, 1999, p.120.

[5] Available at Chinese Central Government Portal Site, http://www.gov.cn/, September 20, 2006.

[6] Shi Jianhuai, "The Adjustment of Global Economic Imbalances and Its Impact on Chinese Economy", (QuanQiuJingJiShiHengDeTiaoZhengJiQiDuiZhongGuoJingJiDeYingXiang), Discussion Paper of China Economic Research Center of Peking University, No.C2006001.

and China were invited by the IMF to join the multilateral consultation. Considering that the foreign reserve management strategy of countries with large dollar reserve had provided the US domestic market with huge amount of liquidity, the global imbalance had contributed to some extent to the origin of financial crisis in the US. However, we also need to take a comprehensive view on this issue. The major cause of the financial crisis came from the irresponsible macroeconomic policy and financial regulatory practices of the US. As far as the issue of rebalancing is concerned, we should bear in mind that it's not just about the change of macroeconomic policies, but also concerned with the transformation of economic development modes of many countries, particularly the developing countries. So it's important to bear in mind the complexity and endurance of the issue of addressing global imbalance.

Basic Positions of Major Economies toward the Reform of International Financial System

As the leading country in the international financial system, the basic position of the US is to continue its dominance of the system and maintain the dollar's status as major reserve currency in the international monetary system. Under this precondition, the US is willing to make certain reform on international financial system in accordance with the change in world configuration of economic powers. Whatever the reform plan, the US only attempts to recruit emerging countries into the international economic system dominated by the US, so as to make the reformed system continue to serve the global and strategic interests of the US. Based on these considerations, the US policy makers agreed to the demand of emerging countries and developing countries for reforming the international financial system. Yet its real attempt is to urge the European countries to transfer their quota and representativeness by using the appeals of developing countries. The outcome of G20 Pittsburgh Summit is to make European countries decrease their quota in the IMF and World Bank. The position of the US hasn't got any substantial influence.

According to the estimates of the IMF, the Euro zone countries suffered greater loss than the US. This also leads to some differences between the European countries and the US. The European countries want to gradually diminish the hegemonic status of the US dollar in the international monetary system and promote the role of Euro. As for the IFIs, the European countries object to the proposal of the US to decrease the seats of IMF Executive Board, arguing that the current structure has legitimacy, inclusiveness, and effectiveness. They also propose to reform the minimum percentage requirement in the IMF decision making process, which may end actual veto power of the US. When the reform of international financial regulatory system is concerned, the European countries demand strict regulation on all the relevant individuals, institutions, and financial products, and they particularly ask for restrictions on the bonus policies of private financial companies in case the current policies provide the management with wrong incentives.

After the crisis, Japan takes its ordinary stance of adhering to the US policy. The only special concern for Japan is to worry about its decreasing role in international financial system, which has been aggravated by the replacement of G7 by the G20 as the major forum for world economic issues. To respond to this new change, Japan has started to reconsider its role in the East Asian financial cooperation process and adopt a policy of closer cooperation with China and South Korea in forwarding the further integration of the three Northeast Asian countries, as well as the major economies in Asia.

As the representing countries of the emerging powers, the BRICs have impressed the world with their rapid economic growth. Due to the long term lack of representativeness and voices in the international financial system, they have expressed strong demand for the reform of this system. This demand also reflects the concerns of most developing countries. June 16, 2009, the BRICs held their first Summit, with leaders from the four countries coming together to discuss the possibility and potential of deeper cooperation among themselves. In the Joint Declaration issued after the Summit, these four emerging countries express clearly the demand for reforming the international financial system.

In conclusion, on the verge of great transformation of the international financial system, all the major economies have actively participated into various forms of multilateral cooperation and coordination, aiming at making the future change of international financial system moving to the direction at their wishes based on their respective calculation of the interests and benefits, as well as costs and obligations.

The Direction for the Reform of International Financial System

1. With the change in world configuration of major economic powers, the need for reform of international financial system has been widely accepted.

The debate over the reform of international financial system has been undergoing for many years. After the breaking out of the global financial crisis, the defects in the current international financial system have become more outstanding, which has called for greater demand from various countries for the execution of the reform.

It's acknowledged that the most vital development of world economy in recent ten years is the emergence of those emerging market economies with developing major powers as their critical representatives. With the growth of China's foreign trade as an example, the five years after China's entry into the WTO have witnessed rapid growth of Chinese foreign trade with an average 29 percent growth rate annually. In 2005, the FDI deriving from developing and transition economies reached 133 billion dollars, about 17 percent of world total investment.[7] With the rise of emerging powers as a group, the world configuration of major economic powers has undergone great change, which has also put forward the demand for simultaneously rising representativeness and voices for the emerging powers in major international institutions. In the meantime, the mistakes in the foreign and economic policies of the US have caused the stagnating growth of its economic power. The EU needs to focus on its internal integration after its rapid enlargement process. This may cost the EU much of its economic resources, and make it hard currently for the EU to reach consensus on a unified external policy. Japan has experienced another impact on its economy after many years of low economic growth. The comparison between the rapid growth of emerging powers and the relative decline of the developed countries demonstrates the inevitable direction for the reform of international financial system.

On the other hand, the deviation of the interests among developed countries has been accompanied by the existence of some kind of common interests between some developed countries and emerging market countries. For instance, the US take an active role in supporting the demand of emerging countries and developing countries on the issue of reform of the distribution of IMF's quota and voting rights. And the common interests between the EU and emerging

[7] UNCTAD, *World Investment Report 2006: FDI From Developing And Transition Economies: Implications for Development*, United Nations, 2006, p.17.

countries exist when the issues of international financial regulatory reform and the surveillance of macroeconomic policies of countries of major reserve currencies are raised.

2. With the multiple influence of different factors, it's hard for the reform to be done overnight.

Although under the backdrop of great change in international political and economic power configuration, there has existed better historic opportunity and stronger driving force for the reform of international financial system, the complete reform still needs time and efforts considering that the power and influence of emerging powers in the international economic system is still limited. Besides that, we also have to take into account the historically inherited sluggishness of the international financial system, the complexity of its scope and components, and the diversity of the interests of various countries.

For the time being, the power of emerging countries still cannot compare to that of the developed countries, no matter soft or hard power. The lack of economic power leads to the gap in available economic resources, which also determines the gap in the ability of management of international financial system. Another element the emerging countries generally in need of is the experiences in participating into international financial activities. This mirrors the lack of sophistication in their domestic financial markets and the need for reform of their domestic economic institutions. These factors constitute the soft restraint on the emerging countries regarding their participation into and advancement of the reform of international financial system.

As regards the momentum and political will for reform, it's possible that with the passing of the crisis, they will also diminish or even disappear. Once the crisis has been mitigated or resolved, the reform will be met with great domestic objections. With the domestic financial situation in the US being stabilized, bigger political impediments to the large scale reform on financial regulatory system also existed. The Wall Street fought back strongly against the federal government's attempt to intervene into its internal governance. So it's not an easy task to implement great transformation of the financial regulatory system. In addition, the appeal for rebalance of world economy and refreshed pressure on the appreciation of Chinese currency make us feel like going back to the days before the crisis, in which the US press hard for China to take greater responsibility as the country with trade surplus while completely ignoring its own obligation as the country with major reserve currency to stabilize the dollar.

Another uncertain element lies in the future development of the G20. The prospect for institutionalization of the G20 is still unclear, which in turn obscures the relationship between the G20 and other global economic governance mechanism as well as the role of G20 in the reforming process of international financial system. Currently, the G20 mainly focuses on the strategic economic issues and provides guiding principles to the major IFIs to implement. The Communiqué of G20 Pittsburgh Summit has made it clear that the G20 will replace the role of G7 as the major forum for global economic issues. However, we still need further specification of the scope of issues to be discussed and method of dealing with these issues.

3. With the existence of great differences in the interests of major economies, the international economic policy coordination has become more complicated.

In the traditional international economic and financial order, international economic policy coordination was implemented among the major developed countries. However, the bursting and continuance of the global financial crisis has brought out new characteristics and demands to international economic policy coordination. This is mainly manifested in two aspects. First, the scope of economies participating into the policy coordination has gone beyond just developed countries, many emerging countries being added to the list after the G20 took the role of G7 in global economic governance. Second, the issue area of macroeconomic policy coordination has become more extensive, including monetary and fiscal policy as well as different countries' economic development modes and adjustment of industrial structures.

As the impact of financial crisis is gradually mitigated, the complexity of international economic policy coordination may increase. Now the major issue facing countries around the world is the post-crisis pattern of global economic development. Since the current global economic imbalance manifests mainly in the imbalance between the developed countries and emerging countries, the domestic policies in need of coordination are not only limited to traditional monetary and fiscal policies, but also include the economic development modes and adjustment of industrial policies of different countries. Under this circumstance, international economic policy coordination is faced up with more complex and difficult situation. The major members of the G20 need to enhance consultation and cooperation, and attach great importance to the complexity and enduringness of the domestic economic adjustment in the developing countries.

4. Compared with the slow pace in multilateral cooperation, regional financial cooperation has acquired relatively stronger momentum.

In order to remedy the defects or deficiencies of current international financial system, the enhancement of regional financial cooperation should work as an effective supplementary or substituting way. After the 1997 Asian financial crisis, the East Asian countries accelerated the process of regional financial cooperation, with many important outcomes having been achieved. During the current financial crisis, the East Asian countries signed a lot of agreements on financial cooperation among themselves, including China. Generally speaking, East Asian countries received relatively little impact of the current financial crisis compared with countries in other continents. One important reason behind this is the existence of extensive financial cooperation in this region. In Asia, the vision of East Asian Monetary and Financial Cooperation had been put on the agenda in the wake of Asian Financial Crisis. According to the estimates of *Business Week* dated February 24, 1997, in East Asian region (including Japan) the insolvent debt reached 660 billion dollars with many banks faced with the problem of liquidation.[8] At the annual meeting of Asian Development Bank held at Thailand's Chiang-Mai in May 2000, Financial Ministers of East Asian countries unanimously agreed to set up a network of currency swaps arrangements in order to prevent possible financial crisis in the future. This currency swaps arrangements were designed as a network of bilateral treaties consisted of swaps and repos of foreign currency reserve of the central banks in the region, with the objective of protecting currencies liable to speculative attacks.[9] On May 5, 2007, the meeting of Financial Ministers of ASEAN countries, China, Japan, and Korea (abbreviated as "10 plus 3") focused their discussions on East Asian regional macroeconomic situation and the enhancement of East Asian financial cooperation. The most important outcome of this meeting was the consensus reached by all the parties concerning the continuing multilateralization of Chiang-Mai Initiative. By setting up a legally binding foreign reserve pool, if there existed crisis and risk, the pool would be put under the joint management of

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[8] Stijn Claessens, *Are Financial Sector Weaknesses Undermining the East Asian Miracle?* Chinese edition, Chinese Financial and Economic Publishing House, 1998, p.3.

[9] Zhang Bin, "Revitalization of Asian Monetary Fund", *Contemporary Asia-Pacific*, (DangDaiYaTai), No.1, 2001, p.18.

all the countries, while each country still controlled its own part in the pool under ordinary circumstances. In the meantime, with the coming into power of the new administration of Japan and the increase of mutual trust in China-Japan bilateral relations, China, Japan, and South Korea have accelerated the process of financial cooperation among the three countries, aiming at enhance the regional economic integration and the ability of preventing and addressing financial risks. This may lead to more substantial financial cooperation in East Asia.

China's Strategic Thinking in Addressing Reform of International Financial System

With the scope and depth of China's participation into international financial system being continuously enhanced in recent years, China has become one of the influential members of the system. Yet China's current position and influence still cannot match up with its real political and economic power. Therefore, China needs to present its own strategic arguments on the coming reform of international financial system, so as to better vindicate China's core interests and reflect the stance and demands of developing countries.

1. Knowing clearly the Extent of China's Capability, Grabbing the Historic Opportunity

Under the background of global financial crisis, the opportunity for China to join the reform of international financial system looms large. This is first due to China's rising economic power and influence. Another contributing factor is the simultaneous emergence of the group of emerging market countries, which has broken the monopoly of international financial system by developed countries alone. Based on these factors, China's voice in international financial system has been improved to a great extent. In the meantime, we must have a clear mind about the real capability of China, which is still bounded by great restraints and limitations coming from both home and abroad. China's major efforts still need to be put on domestic economic reform and development. China is also in desperate want of high-level financial, legal, and management talent with experiences in international markets. And Chinese financial institutions still need to greatly enhance their competitiveness and efficiency. Therefore, China should make the policy of embracing strategic opportunity on the basis of a clear assessment of its own ability and potential.

2. Enhancing Coordination among Major Powers, Striving for Strategic Partnership

To advance the reform of international financial system and get the position comparable with its own economic power, China has to address properly its relations with the major powers. The most important is undoubtedly bilateral relations between China and the US. The US is the largest benefactor of the current financial system. And China is the largest independent variable in this system. Therefore, China and the US need to construct mutual trust and coordinate mutual interests, which is the important precondition for the smooth advance of the financial reform. China and the European Union have similar stance against the US on the issue of financial regulator system reform. Yet their interests deviate on the issue of reforming IFIs, which means they need to communicate on the differences with each other. China and Japan also need to coordinate their stances on such issues as the World Bank reform and East Asian regional cooperation. The countries of the BRICs as well as China and other developing countries also need to acquire consensus and make unified actions. All in all, China needs to continue its high-level bilateral dialogues with various major economies or major powers, so as to make full use of the characteristic of multi-channels, multi-platforms, and multi-fields, and make them match up with and supplementary to one another. In this way, China can fully express its views and stances.

3. Grasping Strategic Focal Point, Pushing for Reform of Major IFIs

Currently speaking, the reform of international monetary system and regulatory system meets with great difficulties. China's preparatory work to address these issues is also not enough. Compared with that, the reform of IFIs has been under discussion and debates for many years, paralleled with the presentation of many feasible working plans. China has a vital interest in this reform as well as great ability to participate into the reform. In the G20 Pittsburgh Summit, the leaders decided that the G20 will be the major forum for global economic governance, with China being one of its important members. Therefore, the current strategic focal point for China is to fully advance the institutionalization of the G20, enhancing its role and influence in the international financial system. The G20 should be the major mechanism responsible for the reform of IFIs including the IMF, World Bank, and Financial Stability Board (FSB).

4. Aiming at Strategic Breaking Point, Advancing the Internationalization of RMB

The internationalization of the RMB constitutes one important part of China's strategy for advancing the reform of international financial system. With the strengthening of China's economic power and openness, its currency also needs to play greater role in serving as one of the international currencies. The internationalization of RMB is also conducive to China's long term development. China could have the priority in managing the stability of the exchange rate of the RMB, without the risk of over-dependent on the exchange rate change of the key international currencies such as the US dollar. Moreover, if the RMB becomes a reserve currency, China will have larger policy space in addressing the imbalance of its balance of payment.

5. Locating Strategic Supporting Factors, Accelerating Development of Hong Kong – Shanghai Financial Axis

Currently, the development of Chinese domestic financial market is still in the "emerging and transitional" phase. It's faced up with double tasks: the deepening of financial marketization; the transition of financial regulatory system to a fully market-based system. And the RMB is still not a fully convertible currency, which has become the most important institutional restraint on Shanghai's efforts in building an international financial center and the process of internationalization of RMB. Yet there are two factors which can provide great support for China's financial development. The first is concerned with Shanghai's potential role in promoting financial development in Chinese mainland, since it's located in the prosperous Yangtze River Delta region and has large developmental space with the vast inland China behind it. On the other hand, Hong Kong has its own advantages of open economy, healthy and competitive financial system, and adherence to the rule of law. These advantages of the two cities are mutually complementary to each other. If we can make good use of Hong Kong's existing characteristics, and dig out Shanghai's potential capability, and also make the two cities closely cooperate with one another, the Hong Kong – Shanghai financial axis could become a great driving force for China's financial development and competitiveness upgrade.