



## **The Crisis Next Time: U.S. Leadership at the Pittsburgh Summit and Beyond**

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What a difference a year can make. Last September, the U.S. financial crisis was spreading with alarming speed to global markets. Many people feared that the world would fall into long, deep recession, perhaps comparable to the Great Depression. The global economy appeared to teeter on the brink of an abyss.

The crisis gave fresh impetus to overdue changes in global governance. An expanded group of nations, the G-20, met for the first time at the head-of-government level, overshadowing the embarrassingly outmoded G-8 as a setting for tackling global problems.

In Washington last November and then in London this spring, the G-20 heads of government put their collective weight behind a coordinated response, including a pledge to make an unprecedented \$1 trillion available to developing countries to ensure they could participate in what amounted to a global stimulus package.

Attention in Pittsburgh will focus on when and how to exit from the stimulus policies, and on banking issues, trade, and financial-services regulation. These are important issues. Poor people in the developing world are being hit hard by the crisis. The underlying causes have not yet been addressed and the recovery is not yet assured.

But to make this summit a success the heads of government must look beyond the current crisis and begin to prepare for the crisis next time.

We don't yet know what form this crisis will take or when it will hit.

We do know that our thoroughly integrated global economy, for all its benefits, is far from risk-free; that the looming threat of climate change creates additional and dangerous risks; and that both of these have special potential for devastating harm to poor people around the world.

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And we know that the premier global institution of international development cooperation—the World Bank—is poorly designed to meet these challenges.

The World Bank’s country-focused lending model and its outdated governance structure leave it ill-equipped to deliver the global public goods—from combating trade protectionism and global epidemics to investing in research on renewable energy and climate-resilient crops—that all nations need but none can provide on its own.

Last weekend in London the finance ministers of Brazil, Russia, India, and China urged the G-20 to become the primary steering group on global financial and economic issues. I agree. To do so, the G-20 must articulate a consensus on the roles of the World Bank and other multilateral financial institutions—and to nudge them to become much more creative and flexible in providing global public goods.

Today I want to offer two proposals for the G-20 leaders in Pittsburgh to look beyond the current crisis and follow through on their pledge in the London Communiqué to make the global economy “*green, sustainable, and inclusive*.” Because the G-20 and other world leader summits are declaring and committing bodies rather than implementing bodies, both of my proposals involve providing instructions to international institutions.

- First, the G-20 leaders should pledge to begin working together—well before their next summit in Seoul—on reaching a consensus on the functions and institutional architecture needed to implement a global climate accord—including fresh thinking about the potential role of the World Bank.
- Second, because climate change and globalization have greatly heightened risks for the world’s poor, the G-20 leaders should call on the multilateral development banks to become much more active in offering countries innovative risk management tools, such as insurance against natural disasters and bonds indexed to their terms of trade.

I am going to explain why I think each of these proposals is crucial to shared global prosperity and especially to the well-being of the five billion poor and near-poor people on our planet, and suggest the implications of each for the multilateral banks. I’ll then tell you why I believe that the U.S. should raise these issues in Pittsburgh and work with other G-20 members to address them well ahead of the fourth G-20 summit in Seoul next spring.

### **Wanted from the G-20: Clarity on the Functions and Institutions for Implementing a Global Climate Accord**

Why focus on climate? And why worry about implementation when an international accord still hasn’t been reached?

There are many other problems that are neglected because of their nature as global public goods (or “bads”) that I would have liked to put forward for G-20 consideration. Much of our work at CGD—on global health, energy, and agriculture, and food security—falls

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into that category. (A sampling of CGD work is available on the tables outside. I hope you will take it home and read it!)

Climate stands out from these others because it is a comparatively new issue, for which the institutional arrangements are still unsettled, and because without action in the next few years, irreversible climate change could wipe out much of the development progress of the past, and put future progress, especially in the low-income countries that are not represented in the G-20, at grave risk.

Here's what we know, as summarized in recent CGD working papers by David Wheeler and colleagues, about the problems the world will face if greenhouse gas emissions continue unabated:

- As the planet gets steadily warmer, the sea-level will continue rising. Some areas will be hit much harder than others. A one-foot rise in sea level, likely within 30 years, will submerge large areas of the Nile Delta.
- Coastal storms are likely to intensify. Millions of people in Asia's low-lying coastal cities will be in critical danger from typhoon-driven storm surges.
- Everywhere, weather will be more variable, with more intense rainfall in some places and more intense droughts in others.
- Agriculture will be hit hard. A CGD study by Bill Cline projected that India and parts of Africa will suffer agriculture productivity losses of 40% or greater by 2080.

What is more disturbing is that all these problems will strike developing countries and poor people especially severely—for three reasons: developing countries are in higher-risk areas; poor families depend more on agriculture; and poor countries and poor people are simply less resilient overall, with fewer economic, human, and institutional resources to manage and adapt to these risks.

### Why G-20 Action is Needed

These problems should be a particular concern for the G-20. The heads of government who will gather in Pittsburgh lead countries that account for more than 80 percent of cumulative emissions of CO<sub>2</sub>, the main greenhouse gas. The summit participants know this and they understand the magnitude of the risks. That's why they pledged to make the recovery "*green and sustainable*" as well as "*inclusive*."

Yet the London Communiqué included just a just a single sentence with a direct reference to climate change:

*"We reaffirm our commitment to address the threat of irreversible climate change, based on the principle of common but differentiated responsibilities, and to reach agreement at the UN Climate Change conference in Copenhagen in December 2009."*

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The reality, however, is that preparatory discussions for the Copenhagen negotiations have been extraordinarily tough, reflecting the treacherous domestic politics in all major emitting countries and tension between rich and poor countries about their respective emissions targets and financing obligations.

The politics are especially worrisome here in the United States. The United States accounts for roughly one-third of the accumulated CO<sub>2</sub> emissions that are driving temperature increases. And U.S. per-capita greenhouse-gas emissions are nearly five times higher than China's and more than 18 times higher than India's.

The developing world rightly insists that U.S. leadership on climate should start with aggressive targets for emissions reduction here. *Those of us in the rich countries who care about development must add our voices in calling for rapid U.S. emissions reductions. And we should push for more aggressive public funding for clean energy technologies, here and abroad—after all, there are huge opportunities in the coming energy revolution.*

But in the meantime, the politics remains extremely difficult. We badly need confidence building measures.

I believe that all parties can agree in principle on the importance of effective implementation of whatever agreement is eventually reached. Beginning now to identify the functions and appropriate institutional arrangements has intrinsic value and it can be a way of creating common ground that can help in getting to yes on a meaningful accord.

### **Agree on the Functions**

Regardless of what agreement is reached in Copenhagen—or even whether an agreement is reached at all—the community of nations will want and need institutional arrangements to execute a variety of core functions that are essential to any collective response to the threat of climate change. These include:

- Reliable data and independent audit to verify compliance with emissions-abatement pledges.
- Regulation, management, and oversight of cross-border trading of emissions offsets.
- Judicial-like functions associated with enforcement of agreements, as the WTO currently does with trade disputes.
- Independent and disinterested review of developing-country proposals for funding for emissions reductions and adaptation to climate change, that is fully acceptable to all parties.

The last function deserves a bit more explanation. Although climate is the ultimate collective action problem, country-based plans are likely to continue to be the basic building blocks of emissions abatement and climate adaptation. Under any future

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agreement, they will be the basis for allocating resources provided by the high-income countries, either bilaterally or through some multi-lateral pooled funds.

Who will decide which proposals are viable? And which proposed costs are credible? And which initiatives best leverage private capital and speed the spread of clean technologies? And what programs can be implemented effectively in what countries?

### **Which Global Institutions Should Perform Which Functions?**

The ideal institutional arrangement would deliver on these tasks in an effective, efficient and equitable manner. Can existing global institutions do that? Are new institutions required? Is there a middle path that would build upon existing institutions but with new incentives for the new tasks?

On one hand, new institutions take time and increase red tape. Though some of these tasks can and will be shared, for some there is no existing institution with both the capacity and the legitimacy to undertake them. In addition, some of the functions cannot be housed in a single institution because of the potential for conflict of interest.

The G-20 leaders must think strategically about which functions the world really needs, and allocate them to institutions that can perform them best. Perhaps the conclusion will be that the world needs a new entity with a narrower focus—though personally I doubt it.

While the arrangements to be pursued will necessarily and appropriately take place under the political auspices of the United Nations Framework Convention on Climate Change or UNFCCC and its Conference of Parties, the very qualities that make these legitimate as political bodies—broad representation—hinder their effectiveness as implementation bodies.

The World Bank—with its comparatively strong technical and fiduciary capacity—raises a different set of challenges. Dominance of decision-making by the high-income countries undermines the bank's legitimacy. It is seen increasingly as a throw-back to a G-7 or G-8 world in a G-20 age.

Many developing countries oppose the idea that the bank would vet their proposals for funding support for emissions reduction. They see this as an extension of the conditionality associated with bank adjustment lending in the 1980s and 1990s, and as subjecting their rights to climate financing (given their low cumulative and current per capita emissions), to the indignities and ineffectiveness of typical foreign aid programs.

Another major flaw is the conflict of interest that arises from a single institution housing both the lending and grant functions, on one hand, and any verification or judicial functions, on the other.

Still, to my mind, there are many benefits to tapping the expertise and capacity at Bank if—and that's a big IF—it were possible to bolster legitimacy and insulate the implementation functions from the World Bank's seemingly endless preoccupation with

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making loans. The fact is, without an explicit international understanding that things should be otherwise, the World Bank will assume many of the implementing functions by default—a process that has already begun.

To resolve these problems, one possibility is to establish an entirely new and legally separate wing of the World Bank, with a distinct mandate, primarily grant funding and a different board that is more transparent, legitimate and ultimately more effective.

Its governance should be shaped by three principles:

- Periodic member contributions should be related positively to per capita income and to emissions per capita;
- Developing countries as a group should have influence equal to that of developed countries, whether through 50 percent of weighted votes or other voting rules.
- In legal and operational terms, the new entity should be as distinct or even more distinct from the main lending arm of the bank as the Multilateral Investment Guarantee Agency (MIGA) and the International Finance Corporation (IFC).

Views on the optimal arrangement will differ—as surely they differ within this room. The lack of serious attention up to now to what functions are needed and which institutions should perform them is understandable in the light of the tensions surrounding the climate negotiations.

But the resulting confusion is unnecessary and counter-productive. And the one thing that the multilateral institutions cannot do is to sort it out themselves. They must do the bidding of their members and shareholders—the sovereign states whose leaders will gather in just two weeks in Pittsburgh. It can only help for the G-20 to begin to grapple with this issue.

### **Beyond Lending and Grants: Risk Management and Risk-Sharing Products for Poor Countries**

This brings me to my second task for the G-20: prodding the multilateral development banks, the World Bank in particular, to develop and deliver a greatly expanded range of risk-management products for poor countries.

The global financial crisis has made millions of Americans acutely aware of the potentially high costs of systemic volatility. Millions of households have seen their retirement savings crumble, their jobs disappear, and more than a million families have lost their homes to foreclosure. These are real and painful losses.

Yet they pale in comparison to the deprivation that millions of poor people in developing countries have suffered a result of the same crisis—not only jobs lost and small businesses under water as in the United States, but also undernourished babies that are permanently impaired and children leaving school to work the streets. These outcomes at the household level prevail even in many countries whose overall growth rates are recovering.

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In fact, for the world's poorest people, this fallout from this financial crisis was just one more in a seemingly unending series of negative shocks: drought, flood, earthquake, typhoon, tsunami, a sudden spike in the price of the foods poor people buy, or a plunge in the price of the crops that they sell.

Why are poor people and poor countries so vulnerable to these shocks?

A rich economy such as the United States is like a powerful ocean liner, resilient in rough weather and choppy seas, its passengers partly insulated from the weather by protective stabilizers. Poor, small economies are like flimsy, heavily laden boats, many packed with passengers, riding precariously low in the water. They are easily swamped by waves—think terms-of-trade shocks, for example—or, as with the financial crisis that started here in the United States, even by the wakes of the giant ocean liners speeding by.

Making the flimsy boats more resilient could help of course, but development takes time. And many of the flimsy boats will always be small, even if they become more seaworthy. Since risks can't be eliminated, the flimsy boats need ways to manage risk—they need insurance.

### **Prodding the MDBs to Provide Better Risk Management Tools**

Right now, the global community provides grants and loans to help small economies deal with shocks. But with a few notable exceptions—including more generous and rapid credit lines the IMF is promising for low-income countries—negotiating a loan is a slow and uncertain process. That uncertainty, on top of the many other risks developing countries face, further deters investment.

Worse, these loans are the equivalent of the rich people in the ocean liners kindly offering to lend money to the poor people in the flimsy boats in order to patch up vessels damaged by the giant ocean liners' wakes!

I believe that the international community can do better. Guillermo Perry, Nancy Lee and I have identified several risk management and insurance mechanisms, that would offer a significant improvement. I'll mention just three examples:

- Global catastrophic reinsurance funds—building on programs such as the World Bank's weather insurance in the Caribbean—could help to insure governments' and households' cash needs in the face of a natural disaster.
- Bonds linked to the terms of trade could enable countries to automatically reduce their debt service payments—that is, the payment they make on the bonds—if they are hit by a sudden price shock, such as a surge in the price of imported oil.
- Global and regional funds that would invest in the domestic bonds of “frontier” countries and firms would reduce the risks associated with foreign-currency-denominated debt in those countries.

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As the reconstituted steering group for the international financial institutions, the G-20 is in a good position to prod the World Bank and the other multilateral development banks to rapidly expand their offerings of risk-management tools.

To make their call for action more effective, the G-20 should signal that future capital increases to all of the MDBs will be based in part on their progress on this crucial set of innovations. A little whiff of competition, combined with sudden worry about the future bottom line, might help the leadership of the World Bank and the other MDBs to overcome the entrenched culture of lending at any cost.

### **U.S. Leadership: A Second Bretton Woods Moment?**

Now let me turn in closing to the role of the United States.

In some ways, the situation today is not unlike that towards the end of World War II. Although we have been spared the cataclysm of global war, we are emerging from a crisis that has badly shaken global confidence and revealed to all the inadequacy of existing arrangements for collective action.

During the 1940s, even before the end of the war, the Allies began the consultations that led to the creation of the United Nations and the Bretton Woods Institutions—the IMF and World Bank—institutions that helped to make the second half of the 20th century much more prosperous and less bloody than the first.

The United States was a leader in that process, rejecting the idea that the task of building a better world was too difficult, or the promise too uncertain, to warrant its best efforts. Instead its leaders looked upon the creation of new institutions as an opportunity to shape the future around the world in accord with U.S. interests and values.

Today, the United States has a similar opportunity to lead. I believe the institutional arrangements we devise now to address climate change and the new risks that have accompanied globalization will be as important in the coming decades as the UN and Bretton Woods sisters were in the 60 years just past.

Now is the time for the G-20—today's equivalent of the Allies in World War II—to begin serious deliberations on the design of the institutional arrangements for addressing common challenges, not only averting climate catastrophe but also other global public goods—including especially reductions in global poverty.

In Pittsburgh, President Obama has a golden opportunity to match the multilateral, smart-power rhetoric of his recent foreign policy addresses with decisive leadership and active collaboration with G-20 members on matters that will affect the welfare of billions of people.

The Pittsburgh Communiqué is probably nearing its final draft as we speak. But that doesn't mean that something of transcendent and lasting value cannot come out of this summit, even if it is primarily a matter of framing the agenda for the next summit in Seoul.

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I hope that Pittsburgh won't be business as usual, that President Obama and the other leaders will have the courage and creativity to think through what is really required to create a "*green, sustainable, and inclusive*" global economy—and to prepare now for the crisis next time.