Implications of the G-20 Leaders Summit for Low Income Countries and the Global Economy

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Thank you Chairman Meeks, Ranking Member Miller and other members of the subcommittee. I appreciate the opportunity to appear before the subcommittee today to talk about the implications of the G-20 Summit for low-income countries and the global economy.

I. Introduction

The twenty-first century is bringing tectonic shifts in the world's political and economic landscape. Today's global challenges—disease, human and food insecurity, climate change, and financial crises—do not respect borders; they threaten security globally and at home. Trade, remittances, and private investment tie rich and poor countries together, creating shared opportunities for prosperity in plentiful times, but also the potential for shared instability and strain, as in our current global economic downturn.

The U.S. cannot hide from these problems within our borders. We are still the global leader, and the world still looks to us for leadership despite out recent financial excesses. But we cannot manage what are fundamentally global challenges alone or even with one or two allies or economic partners. We have to engage actively in cooperative institutions designed to help member countries manage global challenges through effective collective action.

In the global village we have constructed, we live in the center in what is still the biggest house. We started a fire at the center that has spread quickly and puts others in grave danger. We have a responsibility to help – indeed to lead in raising resources to fight the fire and limit its damages not only close to home but further afield among our smaller, poorer neighbors.

An urgent current challenge is to ensure developing countries can cope with the global economic crisis – avoiding setbacks that would undermine the fight against poverty and disease worldwide, and shoring up their fiscal capacity to participate in global demand stimulus.

In this spirit, I am pleased to be here today to offer my perspective on the steps the new administration and G-20 leaders at the London Summit have taken to do more to help developing countries, including the poorest among them, to cope with the crisis. The summit leaders proposed a major increase in resources at the International Monetary Fund (IMF), and my remarks will focus primarily on the position the United States ought to take on that issue and on related proposals for reform and strengthening of the IMF. I will make four broad points:

- **We (Americans) need the IMF.**
- **The Congress should agree to the administration's request for the U.S. to shore up an IMF borrowing facility with a $100 billion loan.**
- **The Congress should endorse the sale of IMF gold, and should provide guidance but not strictures to the administration on the use of the income.**
- **The United States should take stronger leadership and initiative in securing serious reforms of governance at the IMF.**

II. We (Americans) need the IMF

One need look no further than today's global economic crisis to see the promise and peril that increased global integration affords rich and poor countries alike. While this increased global integration has made the challenge of reducing global poverty and inequality more achievable than ever, we also know that the repercussions of financial crises can quickly undermine these efforts all around the globe.

In February 1945, President Franklin D. Roosevelt told Congress that the IMF "spells the difference between a world caught again in the maelstrom of panic and economic warfare …or a world in which the members strive for a better life through mutual trust, cooperation and assistance." Rapid globalization since then has only intensified our need for an institution like the IMF.

There are two reasons why the U.S. should support the IMF right now.

- First: The U.S. recovery from the economic crisis depends not only on our own stimulus package, fiscal and monetary policy and credit and related programs to sustain domestic demand, but on sustaining demand abroad, including in emerging markets and developing countries.

- Second: U.S. prosperity and in the broad sense U.S. security beyond the crisis rely on the open, rules-based international economic order created under our leadership at the end of World War II. The IMF plays a key role in that order, and that order in turn supports the safer, more prosperous and more humane global community Americans want beyond as well as within our borders.

1. Ensuring our economic recovery

In economic terms, emerging market and developing economies have driven much of recent world growth. In 2008, U.S. growth relied almost completely on our exports—about one-third of which went to China, India, Brazil, Mexico and other emerging markets. An estimated 10 percent of U.S. jobs—about 12 million—depends directly on these exports. Now those markets are experiencing dramatic withdrawals of capital and drying up of credit, including trade finance. Remittances are declining as immigrants return home. As commodity prices and exports decline, most developing countries can expect big shortfalls in fiscal revenue this year, meaning that they will not be able to fund the costs of teachers and health workers, let alone their existing bare-bones safety nets.

Helping emerging and developing countries to cope is in our national interest. President Obama explained in his letter to congressional leaders about the G-20 commitments that lower global growth, as in the Asian financial crisis, will cause U.S. growth, jobs, and exports to fall more sharply. Collapsing economies overseas will exacerbate the contracting economy at home. Stimulating the global economy is vital for our domestic recovery.

2. Beyond the crisis: a safer and more humane global community

Continued economic growth in the developing world is not only good for our economic recovery. Economic growth in the developing world reduces the risks of social and political unrest abroad and shores up countries' own efforts to help their own people escape poverty. It also strengthens governments' ability in low-income regions to participate in international programs to reduce drug and sex trafficking and global disease surveillance. (Consider how fortunate the U.S. is that its neighbor Mexico handled quickly and effectively the outbreak of the recent influenza virus.) That in turn promises a more stable and secure world over the medium term, as well as the better world most Americans seek in the interests of our shared humanity.

Now economic growth abroad is threatened by what began as a financial crisis in the U.S. Most of the more than five billion innocent victims of this crisis live in developing countries with limited resources for stimulus packages, let alone for food stamps and unemployment insurance. This is true even in the many developing countries that have had responsible government and economic management for some two decades.

In sub-Saharan Africa, for example, where the number of democracies has risen from just three in 1989 to 20 today, governments are increasingly committed to sensible macroeconomic management and effective health and schooling programs. They have achieved faster economic growth, continued reduction in poverty rates and improvements in social indicators. But they are not in a position to borrow to support countercyclical fiscal spending, the poorer among them face likely declines in bilateral aid, private capital has withdrawn (in a flight to the relatively safe haven of U.S. treasuries) and their governments cannot borrow on dried-up private capital markets. For the poorer countries especially, external resources are critical to avoid extensive human suffering. The International Labor Organization predicted earlier this year that as many as 50 million jobs will be lost in the developing world (and that estimate has probably risen with a reported 20 million jobs lost in China export industries alone). The World Bank is projecting zero growth in per-capita income in Africa.

The United States, as the catalyst for this crisis, has a particular responsibility to help poor countries cope with the fallout. Though in the major developing countries there is as yet no sign of rejection of our market-based and democratic model, it is not surprising that their leaders and their peoples look to us for leadership in helping those with fewer resources to cope. Were we to walk away from that leadership, a backlash of anger at the United States and opposition to U.S. values, institutions, investment and trade could develop; certainly the leaders of Venezuela, Iran and even Russia might exploit the situation in ways against our interests.

3. The role of the global financial institutions

To return to the metaphor I used at the start of my testimony, I'd like you to think of the IMF as the fire brigade in our global village. That is the approach that the G-20 leaders took. They resolved to rapidly increase the fire brigade's resources to minimize the risks of the financial fire spreading worldwide and damaging everyone – and strengthen its capacity to participate in a more effective regulatory regime within and across countries to minimize the likelihood of future fires.

They also acknowledged the importance of the work of the World Bank and the other multilateral banks in supporting continued and compensatory spending in affected countries on social safety net programs and infrastructure and other investments to speed recovery.

The distinction between the roles of the two institutions—including in the absence of crisis—is relevant for the use by the IMF of the income from the proposed sale of some of its gold. The World Bank's purpose is to help developing countries reduce poverty and increase growth by providing low-cost financing and technical assistance for investments with medium-term benefits, in health, education, public administration, agriculture, and so on. The IMF's mission is to help countries manage balance of payments and related macroeconomic and exchange rate problems, both in the case of individual countries needing to adjust and in the interests of minimizing global systemic financial instability. The IMF does this through surveillance of members' macroeconomic and financial policies, accompanying advice and, where necessary, short-term lending.

When there are no fires, the fire brigade may seem irrelevant. But we know that fires happen and when they do, every resident in the village relies on the fire brigade to put out individual fires before they can spread and endanger everybody. The IMF, like the fire brigade, requires sufficient resources to fight fires and take all possible steps to prevent them from happening in the future. (In contrast, the World Bank is more akin to the community development guy in the mayor's office that encourages investment in difficult neighborhoods.)

III. The U.S. should agree to a loan of $100 billion to the IMF

Leaders from more than 20 major nations resolved at the April G-20 London Summit communiqué to make available an additional $1 trillion through the IMF and other institutions to help developing countries cope with the global financial crisis.[1] The Obama administration played a key role in getting the ball rolling in March when Treasury Secretary Timothy Geithner urged that IMF member countries agree to a $500 billion increase in the amount the IMF can borrow from members through the New-Arrangements to Borrow (NAB) emergency financing mechanism and indicated he would seek $100 billion from the United States.

President Obama has asked Congress to include provision for the $100 billion loan in legislation as early as possible and I urge this subcommittee to support that request. The U.S. contribution will help ensure other announced contributions: $100 billion from the Europeans, another $100 billion from Japan (additional to $100 billion announced prior to the London Summit, see http://www.imf.org/external/pubs/ft/survey/so/2009/NEW021309A.htm), and smaller contributions from Canada, Saudi Arabia, and others**.** The "contribution" from the U.S. would have no effect on the U.S. budget; when the U.S. contributes to the NAB, Treasury receives an interest-bearing account at the fund in return, so the net effect on the federal budget is zero.

The G-20 leaders also agreed to IMF issuing $250 billion in new Special Drawing Rights (SDRs— an IMF asset based on a basket of key currencies against which member countries can borrow). Issuing new SDRs is the equivalent of creating additional international liquidity for IMF member countries, a reasonable idea when many credit-worthy sovereigns have poor access to credit, exacerbating the downturn and increasing the risks of global deflation. An allocation of $250 billion is permitted under U.S. law following a 90-day period of consultation with Congress; I understand Treasury informed Congress on April 13. SDRs are allocated to countries in line with their current "quota shares" in the IMF. While just 32 percent of the $250 billion ($80 billion) would go developing countries, about $11 billion would go immediately without discussion or conditions to low-income countries (corresponding to the 4.5 percent of IMF quotas they have). **I support the idea of an additional $250 billion of SDRs being created and called for this before the London G-20 summit. Today, I urge the Congress to endorse heartily this move.**

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[1] I proposed that $1 trillion could and should be made available in mid-February (How to Unlock the $1 Trillion that Developing Countries Urgently Need to Cope with the Crisis), primarily by exploiting then-current resources but also by channeling reasonable amounts of additional resources from the U.S., Europe, and China and other surplus reserve countries through the IMF and multilateral development banks.

IV. The Congress should endorse the sale of IMF gold for two purposes[2]

President Obama has also requested congressional approval for the sale of a limited amount of the IMF's gold reserves, for two purposes: to support an endowment at the Fund, explained below, and to increase the Fund's resources for concessional lending to low-income countries. **I urge the committee to recommend approval of the gold sales request and provide guidance to the Treasury for its discussions with other IMF members on the allocation of the sales revenue between the two purposes.**

In 2008, the IMF board agreed, subject to approval by its members, to the sale of a small amount of its gold to finance an endowment account, the annual returns to which would be available to support the administrative costs of two key public goods the IMF provides: periodic surveillance of countries' macroeconomic and financial situations, and capacity building. Effective surveillance is a core IMF duty and no more so than now, when the IMF is assessing whether the macroeconomic and financial sector policies of its members are adequate given the crisis. The surveillance function can be thought as equivalent to the fire brigade checking to see if fire alarms are working and buildings are up to code. A strengthened IMF surveillance function would not only help individual countries to avoid big mistakes and but also identify—*before a crisis strikes*—systemic risks to global financial stability.

For this to work, dedicated funding for an independent surveillance must be provided on an ongoing basis, not only in times of crisis. In the past the surveillance and capacity building functions have been supported by income from the IMF's loans. But the ability of the IMF to carry out these key functions should not be a function of member countries' needs to borrow (which ideally will return to being relatively limited) nor on the cost of borrowing, which should be as stable and predictable for borrowers as credit markets allow.

The sale had been recommended as one of several options to finance IMF administrative expenses in a 2007 report (the Crockett report). At then-current prices the sale would have yielded about $6 billion in income for an endowment fund – covering a good portion of the target amount sought.[3] It would have generated annual income on the order of about $200 million (SDR 130 million), an amount that today would cover about 20 percent of current annual administrative expenses.

Since the 2007 Crockett report the price of gold has increased, so the revenue could be greater than originally expected. At the April summit the G-20 leaders recognized that revenue from IMF gold sales, in addition to funding an endowment, could help to "provide additional concessional and flexible finance of $6 billion for the poorest countries over the next 2 to 3 years." If the gold is eventually sold at today's price of about $900 an ounce, the revenue,

[2] I made changes to this section in the afternoon of May 12, prior to the hearing but after the posting of my original written statement. The changes reflect information provided by IMF staff on the target amount for the endowment fund ($11 billion), and of the target annual income from it ($300 million). These figures are possibly included in the Board document reflecting Board agreement in April 2008 to fund the endowment solely from the sale of gold, which was possible given the higher price in 2008 compared to 2007. The Board document has not been made public.

[3] See footnote 1 regarding the target amount. All these figures are rough estimates at best, in the interest of providing the subcommittee with some feel for the revenue the gold sales might raise.

allowing for a reasonable amount going back to fund IMF reserves, would be sufficient to cover the originally envisioned endowment while also providing additional resources for concessional lending to low-income countries. The exact amount available for additional concessional lending depends on the price of gold at the time of sale, and the allocation for the endowment already agreed by the IMF Board.[4]

I suggest the Congress support use of revenue from gold sales to provide additional resources to low-income countries consistent with ensuring adequate permanent funding of the endowment. Congress should urge the Treasury to secure as much as possible for such lending, while leaving the final numbers and allocation for Treasury to negotiate with other IMF members.

Regarding the hoped-for additional resources for IMF support to low-income countries I would like to emphasize several points.

First, **these resources should be used to assist low-income countries for the same reasons and fundamentally under the same rules as when the IMF assists middle-income countries**. This means offering relatively short-maturity loans to help countries manage balance of payments and capital account problems, and possibly for bank recapitalization and short-term financing of countercyclical spending to sustain social programs. Such short-maturity lending is the proper remit of the IMF and stands in contrast to its Poverty Reduction and Growth Facility, the PRGF, which over the past two decades has made loans with longer maturities for structural and medium-term development goals.

Why this distinction? In my view, the development-focused PRGF lending has distracted the IMF from its core macroeconomic and financial sector work in low-income countries, leading it to devote scarce time and managerial talent to programs where the World Bank's expertise and facilities would have been more effective and appropriate. Worse, the IMF's PRGF lending inadvertently exacerbated the problem of unsustainable debt in many poor countries.

Second, while **the reasons and rules for an IMF loan to low-income and middle-income countries should be the same, the low-income countries should pay less**. The $6 billion the G-20 proposed, including money from the sale of gold, should be used to ensure those costs are no greater than those charged by the IDA facility at the World Bank, and should if possible include outright grants for the poorest among the low-income countries (e.g. those with annual per capita income at $500 or less). These more attractive terms are necessary to minimize the

[4] Congressman Barney Frank, has said that he supports congressional authorization of IMF gold on the condition that $4 billion of the proceeds goes to poor countries. My original written testimony earlier suggested that the additional resources from the IMF Board-approved gold sale could amount to $4 billion, the amount included in Congressman Barney Frank's statement. However IMF staff inform me that it is not clear that this much would be available over and above the amount the IMF Board designated for the endowment, given that the Board did not approve use of other possible sources of income for the endowment, and possibly given assumptions or decisions about the amount of revenue from the sale to be returned to reserves. For the Congress to designate a specific amount at this stage would probably require a renegotiation with all 185 IMF members of the gold sale arrangement, which would unduly delay the process and the access to any additional resources for low-income countries from gold sales.

risk that poor countries will accumulate unsustainable debt in trying to cope with the effects of an external shock for which they have no responsibility.

Third, the **Congress should instruct the Treasury to urge the IMF to provide loans and grants to low-income countries with less conditionality than usual for the next two years, given that their dire straits are the result of a global systemic crisis rather than shortcomings in their own economic policies.** This is not to suggest that conditionality is always wrong. In normal times the conditions attached to an IMF loan may be a crucial catalyst for politically difficult reforms, such as reducing a runaway fiscal deficit. Even so, in recent years the IMF has recognized the limits of excessively detailed conditionality and has streamlined conditions. Similarly, the IMF recently introduced a Flexible Credit Line (FCL) that middle-income countries with solid macroeconomic track records can tap with no questions asked. These no-hassle loans should now also be offered to low-income countries with similarly sound track records on macroeconomic policy and overall management of government resources. For the reasons I explained above, however, the low-income countries should be charged substantially less.

Finally, the IMF should be asked to assess the logic of using some of the additional resources for low-income countries for precautionary facilities like the FCL for middle-income countries (under which eligible countries are approved for access to future credit if and when needed at no cost until and unless they draw down). This and other insurance and risk management products (including a moratorium on any debt service in the event of external shocks, as I have proposed to this committee in the past[5]), might increase confidence of local and foreign investors and help restore credit in some countries; as in the case of home insurance against fire, it would also provide an incentive for countries to take steps to minimize their own exposure while helping them avoid repeated rounds of new debt when they are hurt by a fire started elsewhere.

To summarize, I believe Congress should authorize IMF gold sales for the two purposes, and provide guidance to Treasury along the following lines: to ensure the proposed endowment is adequately funded and to support allocation of additional gold sale revenue for financing stand-by style loans on highly concessional terms, and grants to the very poorest countries, over the next two years. In addition the Treasury should encourage development of precautionary lending, such as the Flexible Credit Line, and other risk management facilities for the low-income countries. The Treasury should make appropriate decisions on a case-by-case basis, within broad guidelines set by the Congress.

[5] See my testimony on the Jubilee Act before the Senate Foreign Affairs Committee, April 24, 2008. Available online at http://www.cgdev.org/content/opinion/detail/15880/ . Also see page 39 of CGD's first book, *Delivering on Debt Relief: From IMF Gold to a New Aid Architecture* by Nancy Birdsall and John Williamson, a senior fellow at the International Institute for International Economics, which helped frame the discussions on the future of the Heavily Indebted Poor Countries Initiative and how it is financed (see http://www.cgdev.org/content/publications/detail/2922/).

V. Congress should push for faster and further governance reform of the IMF

The global financial crisis requires a global response not unlike what the IMF was designed to do after World War II. But while the economic weight of countries has shifted dramatically since the 1940s, IMF decision-making rules have remained largely unchanged. These out-dated mid-twentieth century governance arrangements are inadequate to provide the legitimacy that is crucial if the IMF is to be effective in addressing the current crisis and averting future global financial disruptions.

As I explained earlier, no one stands to gain more from a legitimate and effective IMF than the U.S. and strengthening the IMF's role in supporting global economic recovery is essential to our own financial recovery. We also know that economic and financial instability threaten political stability and international security. The IMF's ability to help developing countries cope with the economic crisis is therefore critical to restoring economic and political stability globally and at home. It is in our direct national security and economic interests to make the IMF a more credible and effective global financial institution. This is only possible if major emerging market countries have a much larger role in both IMF decision-making *and* in providing financial resources. The G-20 leaders recognized at the summit in April and their call for additional resources for the IMF is twinned, smartly, with calls for governance reform.

The IMF Board last year approved a proposal for revision of IMF quotas (voting weights that determine contributions to IMF resources and access to IMF financing) to begin increasing the quotas of several underrepresented emerging markets. The reform requires congressional approval and the Obama administration has asked for that approval. The proposed changes are very modest (e.g. China's voting share would increase from 3.7 to 5.6 percent); they are sometimes called "a mouse" compared to the extent of reforms needed.

Despite these shortcomings, **I believe that Congress should now endorse the proposed 2008 governance reforms as a first step, a down-payment, towards broader governance reform.** The G-20 called for the next review of IMF quota reforms to be completed by January 2011; an IMF internal report moves this forward to 2010. The U.S. should support an accelerated review process and urge further changes, which can in turn push the Europeans towards accepting deeper reforms—including the important step of reducing the number of board chairs they currently occupy.[6]

Congress can help by urging the administration and Treasury to actively support governance reforms to make the IMF more legitimate and effective. Steps that the IMF could take to increase its legitimacy and effectiveness include:

- **Adjustment in the rule that governs the share of votes required for major IMF decisions.** The U.S. currently holds nearly 17 percent of IMF quota shares. Because major decisions require *85 percent approval by weighted votes from all members,* whether or not they vote, situations arise where the U.S. can block a decision merely by abstaining. By changing the approval requirement to *85 percent of all weighted votes*

[6] As recommended in the Trevor Manuel report: http://www.imf.org/external/np/omd/2009/govref/032409.pdf.

cast, the IMF could boost the voice and power of smaller share holders. The U.S. would retain the ability to exercise a *de facto* veto by voting *against* a decision when necessary. But the U.S. could also chose to abstain and quietly let some things go through. This seemingly minor change would provide greater voice for major emerging economies, which is critical for strengthening the institution's relevance, legitimacy and effectiveness.

- **Double-majority voting.** Double majority voting—that is, requiring a majority of weighted votes (country shares) *and* a majority of individuals countries on a one-country, one-vote basis—would be akin to the U.S. bicameral legislative arrangement in which small and large states have equal representation in the Senate while the House of Representatives is weighted by population. The IMF could start double majority voting on select issues such as future elections of the heads of the institution. Double majority voting is not pie-in-the-sky; it is now the rule at three regional multilateral banks: the Inter-American Development Bank, Asian Development Bank and African Development Bank. (See Double Majorities at the World Bank and IMF—for Legitimacy and Effectiveness http://blogs.cgdev.org/non-commission/2009/03/19/double-majorities-at-the-world-bank-and-imf%e2%80%94for-legitimacy-and-effectiveness/).

- **Formalize the G-20 leaders' agreement on open, merit-based selection of the head of the IMF (and the World Bank), with a clear understanding that the process should proceed without regard for nationality.** Traditionally the IMF has been headed by a European, and the World Bank by an American. The institutions should resist these traditional practices and ensure there is an open, merit-based system that would allow for non-U.S./European leadership.

- **Modernize board arrangements to cut costs and reduce meddling in day-to-day IMF decisions.** Current arrangements for a full-time resident board are outmoded in an age defined by rapid, cheap air travel and instantaneous zero-cost communications. Administrative costs and micro-management of IMF decisions by the board can be greatly reduced by shifting to a part-time resident board, with the members composed of the senior economic counselors at countries' Washington D.C. embassies assigned for one day a week or one week a month to IMF business.

VI. Conclusion

In a an increasingly interdependent world, economic growth, improved well-being and good political relations with developing countries—where five of six people in the world live—are fundamental to sustaining and increasing the economic opportunities Americans enjoy and to reducing the threats we face—in an manner not heretofore seen in U.S. history. In this context, shared institutions matter more, and a better approach to organizing and supporting these institutions can have high returns for the goals and interests of the United States and the global community in which we live.

The challenge is to use America's still substantial influence to reform international institutions into effective organizations for collective, global problem solving. The G-20 members, with substantial leadership from the U.S, have taken the first steps towards strengthening the IMF's ability to provide the global public good of financial stability for all. I hope that the Congress and the administration continue to support strong U.S. leadership on these issues and believe that we and our fellow global citizens stand to benefit greatly from these steps towards a better, more stable world.

To do so the IMF will need two things: significantly more resources and robust reform of its decision making rules. These elements are inextricably linked. Marshalling more resources and using them wisely depends on improving the legitimacy and effectiveness, which are weak because developing countries, whose governments and peoples are the main objects and beneficiaries of IMF activities, are poorly represented in its governance structure.

Tackling resource and governance issues at the IMF will reap rewards for rich and poor countries alike. Strengthening the IMF's role as a legitimate and effective institution will help it respond to the current financial crisis and provide early warning and surveillance data to prevent such crises in the future. While many blame the U.S. for the current crisis, we can and should leverage our leadership and resources through global institutions like the IMF to respond to the current crisis, help restore the U.S. image in the world as a global partner, protect our shared economy, and promote our common security.