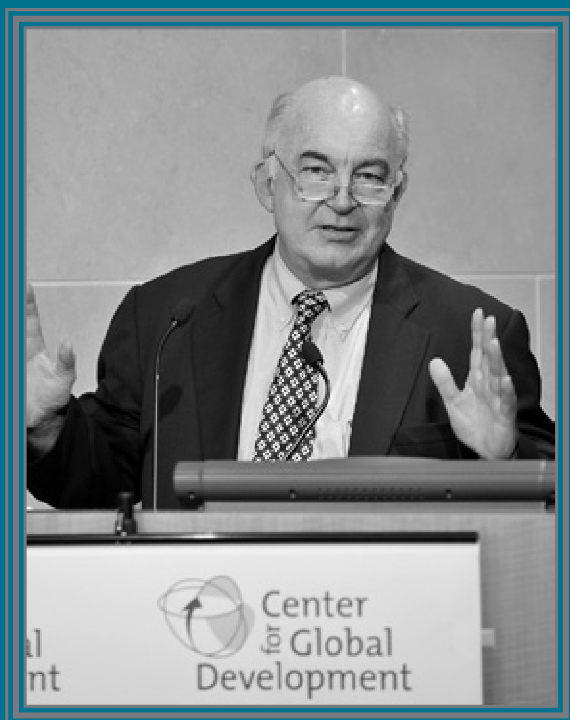
Precautionary Resources and Long-Term Development Finance: The Financial Role of the Bretton Woods Institutions after the Crisis

Kemal Derviş



The Fourth Annual
Richard H. Sabot Lecture

June 2009

The Center for Global Development

The Richard H. Sabot Lecture Series

The Richard H. Sabot Lecture is held annually to honor the life and work of Richard "Dick" Sabot, a respected professor, celebrated development economist, successful Internet entrepreneur, and close friend of the Center for Global Development (CGD) who died suddenly in July 2005. As a founding member of CGD's Board of Directors, Dick's enthusiasm and intellect encouraged our beginnings. His work as a scholar and as a development practitioner helped to shape the Center's vision of independent research and new ideas in the service of better development policies and practices.

Dick held a Ph.D. in economics from Oxford University; he was Professor of Economics at Williams College, and he taught at Yale University, Oxford University, and Columbia University. He made numerous scholarly contributions in the fields of economics and international development, and he worked for ten years at the World Bank.

The Sabot Lecture series hosts each year a scholar-practitioner who has made significant contributions to international development, combining, as did Dick, academic work with leadership in the policy community. We are grateful to the Sabot family and to CGD board member Bruns Grayson for support to launch the Richard H. Sabot Lecture Series.

Previous Lectures

2008 Lord Nicholas Stern, "Towards a Global Deal on Climate Change."

2007 Ngozi Okonjo-Iweala, "Corruption: Myths and Reality in a Developing Country Context."

2006 Lawrence H. Summers, "Harnessing the Development Potential of Emerging Market Reserves.

Kemal Derviş

Kemal Derviş is vice president and director of the Global Economy and Development Program at the Brookings Institution. Until February 2009, he was the executive head of the United Nations Development Program and chair of the United Nations Development Group. In 2001–2002, as minister of economic affairs and of the treasury of Turkey, Derviş was responsible for launching Turkey's successful recovery from a devastating financial crisis. He is also a member of the Board of Overseers of Sabanci University in Istanbul and will contribute to the work of that university, particularly on European enlargement issues.

Prior to his tenure as minister of economic affairs, Derviş had a 22-year career at the World Bank, where he became vice president for the Middle East and North Africa in 1996 and vice president for poverty reduction and economic management in 2000. At the World Bank he also managed work on the reconstruction of Bosnia, on the transition of Eastern Europe after the fall of the Berlin wall, and on trade and financial sector policies in emerging markets.

Derviş earned his Bachelor and Master's degrees in economics from the London School of Economics and his Ph.D. from Princeton University. He also taught economics at Princeton and the Middle East Technical Universities before joining the World Bank.

He has published many articles in academic journals as well as current affairs publications. His most recent book, *A Better Globalization,* was published by the Center for Global Development in 2005. Derviş is fluent in English, Turkish, French, and German.

Precautionary Resources and Long-Term Development Finance

It is a real honor to be here this evening to give the fourth lecture in memory of Dick Sabot. I knew Dick while we were working at the World Bank together and have the fondest memories of our conversations in the corridors or over coffee. Sometimes they were about human development; at other times they were about the internal affairs of the World Bank. I did not know him as well as Nancy did, but I knew Dick enough to admire his deep commitment to development and his intellectual honesty and curiosity.

He was committed to development and to the Center for Global Development, and we are here today to remember him and to honor his commitment. The Center has continued to grow and strengthen under Nancy's impressive leadership. It is now at the forefront of the development debate in Washington and, increasingly, worldwide.

Many of you already know that CGD has a very special place in my life and in my heart. I started my working life as an academic, teaching first in Turkey and then at Princeton. But then, wanting to be closer to policy and wanting to work on development worldwide, I joined the World Bank, first briefly on the research side where I co-authored a book on development planning, but quickly moving into operations. After long years as a manager in the operations part of the World Bank, followed by my return to Turkey as Minister of the Treasury and Economic Affairs, I had "learned by doing" and accumulated experience. I had managed to write quite a few short articles, but life as a World Bank operational manager and then as a minister in my own country, at a time of acute crisis, had not allowed me to really collect my thoughts and write them down. Nancy and CGD gave me that opportunity during the summers of 2003 and 2004. I had been elected to the Turkish Parliament but was

I am particularly grateful to Masood Ahmed, Amar Bhattacharya, Nancy Birdsall, Jose Antonio Ocampo, and Hamid Rashid for their comments. I am also grateful to Isaac Sorkin for excellent assistance.

on the opposition benches with no government responsibility; parliament was not in session during the summer, so I got to write my book at CGD.

Today, back in Washington after almost four years of managing UNDP—years which I appreciated very much and which allowed me to draw further lessons from experience—I would like to use the opportunity of this lecture to return to some of the essential themes of my CGD book and to take a fresh look at the financial role of the two institutions that the current world economic crisis has again propelled into a leading global role. I say financial role, because that is what I am going to focus on. The institutions have a role beyond providing finance, in policy coordination, knowledge sharing, and global issues management, but these are not the primary topics of my talk today.

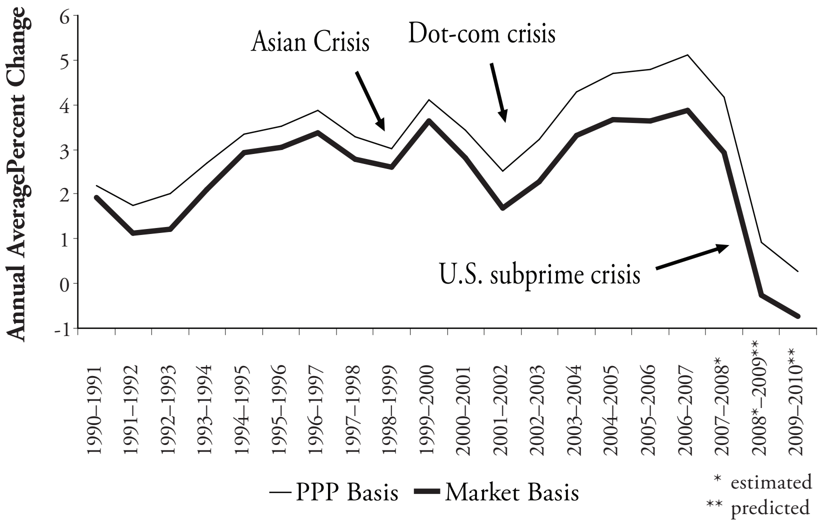
The worldwide crisis

First, a few words about the crisis. Some of us predicted a crisis, but very few predicted fully the *nature* of this crisis we are living through. In a speech at the Ex-Im Bank of India last year in March, I talked about the repeated interruptions of an accelerating global growth trend caused by financial-sector difficulties. Figure 1 is updated from my Mumbai lecture and focuses on how, three times in a decade, financial-sector problems have led to growth slowdowns.

While I had focused on the financial-sector causes of the growth slowdowns in Mumbai, I did not predict the near collapse of the financial sector in the United States and Europe. I thought that strong countercyclical fiscal and monetary policy in the rich countries could again arrest the crisis, as it had been able to do in 2001–2002 after the dot-com bubble. I did stress that preventing future crises from originating in the financial sector would require dealing with the structural problems of that sector, problems relating to corporate governance, regulation, and incentives, rather than simply relying on countercyclical macroeconomic policy, which would only be a short-term cure and might actually sow the seeds of a further crisis later, down the road. However, I did not fully understand exactly how excessive leverage had become, how leverage had often degenerated into Ponzi-type schemes, and how a major restructuring

FIGURE 1

Global Growth Rate, Two-Year Rolling Average, 1990–2010



Source: IMF, World Economic Outlook *(IMF, April 2009)*

and recapitalization of the financial sector could no longer be postponed. To handle this crisis, lowering interest rates to near zero and enacting expansionary fiscal policy would no longer be enough. Massive public intervention in the financial sector itself would also be required.

Most of the sharpest observers did not grasp the full nature of the problem either. Martin Wolf of the *Financial Times* had raised a general alarm, early and repeatedly. But his excellent book, *Fixing Global Finance* published last year, which contains some of the best analysis of world financial markets, ends as follows:

> A different world must now be envisioned, one in which capital flows productively and safely to poor countries. The correction of the US current account deficit now under way makes this both necessary and

> desirable. Can it be done safely? Or will another huge round of financial crisis take place *in the emerging countries* at some point within the next decade? That is the question to be addressed.[1]

At that time, Martin did not predict that the crisis would actually start in the United States.

Larry Summers, in the first Sabot lecture, also started with reference to this so-called "Lucas Paradox" stressing that an observer from Mars would be very startled to see that capital on planet Earth actually flowed, so to speak, uphill, from the poor to the rich countries. [2] This indeed has been the case during the decade after the Asian financial crisis with developing countries as a whole accumulating 3.8 trillion dollars of reserves by 2008.[3] The overall flow of capital has, of course, been complicated, and countries within groupings by income levels have not behaved in a homogenous way (Germany and Japan ran large surpluses; the UK and Spain, large deficits), so the story is much more complicated. But the fact is that the United States, by far the largest rich economy in the world, absorbed a large amount of developing-country savings by running a huge current deficit year after year. Net *private* capital flows *toward* developing countries, interrupted by the Asian crisis, resumed their growth after the turn of the century, but they were more than matched by official reserve flowing in the opposite direction, driven both by mercantilist motives and precautionary reserve accumulation. Figure 2 (page 6) summarizes this counterintuitive story characterizing the decade from 1998 to 2007.

As seen in Figure 3 (page 7), almost half of the financing of the U.S. current account deficit came from official flows until 2007, reflecting reserve accumulation in emerging and developing countries. In 2008, the situation changed with massive repatriation of assets held by Americans abroad leading to large

1. Wolf, *Fixing Global Finance,* 196.

2. Lucas, "Why Doesn't Capital Flow from Rich to Poor Countries?" 92–96.

3. Reserves for developing and emerging markets stood at 20.5 percent of their GDP in 1998 and rose to 26.9 percent of their GDP in 2008. Source: IMF International Financial Statistics Database.

private inflows into the United States—and a sharp drop in official demand for dollar reserves.

Like others, Larry Summers drew attention to the resource cost of this reserve accumulation invested in short-term debt instruments, mainly U.S. Treasuries, by poor countries. [4] In his Sabot lecture, Summers specifically focused on the low financial returns of reserve holdings in low-yielding investments, mainly securities and U.S. Treasury securities. He said: "Think about it. If a country is able to deploy 10 percent of GDP in a way that produces an extra 5 percent return, that's half a percent of GDP in free money to the government." The 5 percent Larry was referring to was the equity premium he assumed could be earned by these countries "[i]f they took these excess reserves and invested them in a diversified portfolio of equities from around the world."

Well, I am not sure Larry was right, at least if we consider the three-year period after his Sabot lecture. If a central bank had invested in the kind of diversified equity portfolio he referred to, as measured by the Standard & Poor's 500, it would have earned a negative return of 10 percent annually, compared to a positive return of about 1.3 percent annually produced by short-term treasuries, in the period from June 1, 2006, to June 1, 2009![5] That does not of course mean that a totally risk-averse strategy will always be optimal for a central bank—or indeed for a university or think-tank endowment. Over the long term, Larry will probably remain right, whether one uses stock market indices or other more comprehensive rate-of-return estimates on real capital stock as a comparator.[6]

But the current crisis has redefined "the long term" when it comes to the equity risk premium. Not only are central banks even less likely to invest in anything but the most conservative assets, but, because it is the countries with

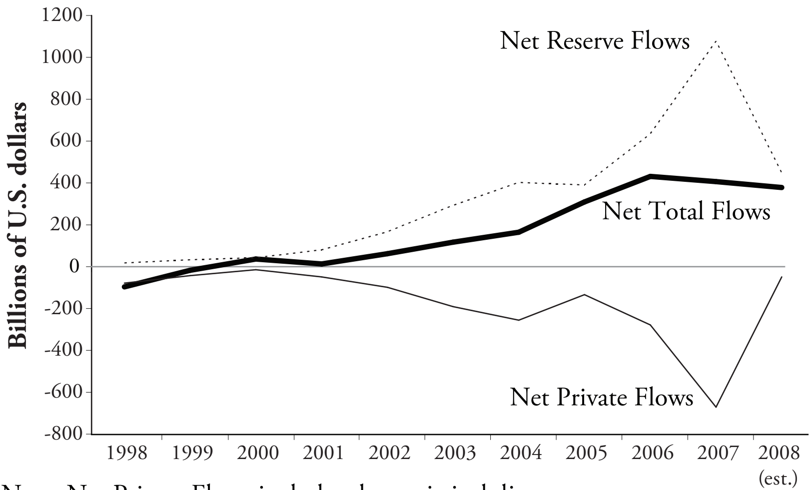
4. See, for example, Rodrik, "*The Social Cost of Foreign Exchange Reserves.*"

5. The cumulative returns are –27 percent for the S&P 500 and +4 percent for short-term (one-month) Treasuries.

6. A country can accumulate reserves by current account surpluses or net borrowing. In the first case it forgoes real investment; in the second case it must pay interest on its net borrowing.

Figure 2

Capital Flows from Poor to Rich Countries



Note: Net Private Flows includes the statistical discrepancy

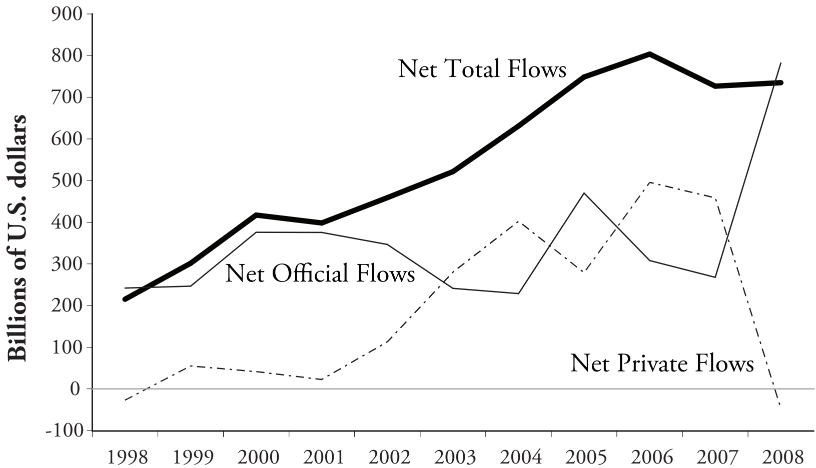
Source: World Bank, Global Development Finance, http://publications.worldbank.org/GDF/

huge reserves that have been able to protect themselves relatively well against the current disaster, the demand for precautionary reserves by developing countries is only likely to increase in the aftermath of the crisis. This would not be good for the unwinding of global imbalances, as it would require large balance of payments deficits in one or a group of rich countries supplying these reserves (mostly the United States but to some extent it could theoretically also be the euro-zone and Japan). Moreover, the real resource costs for the reserve-accumulating developing countries would remain significant as long as the real return on capital accumulation foregone or the cost of borrowing is higher than what is earned on these reserves.

The IMF and Precautionary Finance

Beyond the immediate need for emergency finance, the crisis has again underlined the need for a less costly, balanced way to provide precautionary finance to the

FIGURE 3



Note: Net Private Flows includes the statistical discrepancy.

Source: U.S. Bureau of Economic Analysis

world economy. Precautionary finance, by definition, should be able to become emergency liquidity when needed. In countries with hard currencies, where the national central banks can increase the money supply without the danger of a precipitous decline in the value of their currencies, the monetary authority is a source of precautionary finance through the rediscounting and other facilities that it makes available. The Federal Reserve or the European Central Bank (ECB) can make large amounts of liquidity available to the U.S. or the European banking systems without facing the danger of a collapse in the price of the dollar or the euro. This has allowed the kind of rescue operations we witnessed over the last two years. The same cannot be said for typical emerging-market economies. Because their national currencies are not reserve assets in the international economy, the currencies cannot be increased in a major way without triggering a precipitous decline in their value, and they are not generally accepted beyond national borders, making large-scale rescue operations very difficult or impossible.

It is interesting to note in this context that, contrary to expectations of many economists, the demand for reserves in developing countries did not at all decrease with the greater exchange rate flexibility that characterizes the last two decades. In the old models of fixed exchange rate economies, the demand for reserves was assumed to be equal to a certain number of months of imports. Three months of imports was considered the minimum amount necessary to allow a country to manage short-term fluctuations in its current account transactions without having to change its exchange rate. Six months of imports was considered safe. It was also assumed that if exchange rates became flexible, the rationale for holding significant reserves would disappear, since exchange rates could move and become the shock absorbers, leading to adjustments in both the relative price of tradables and in real absorption. In fact, with a perfectly floating exchange rate, there would seem to be no need for reserves at all.[7]

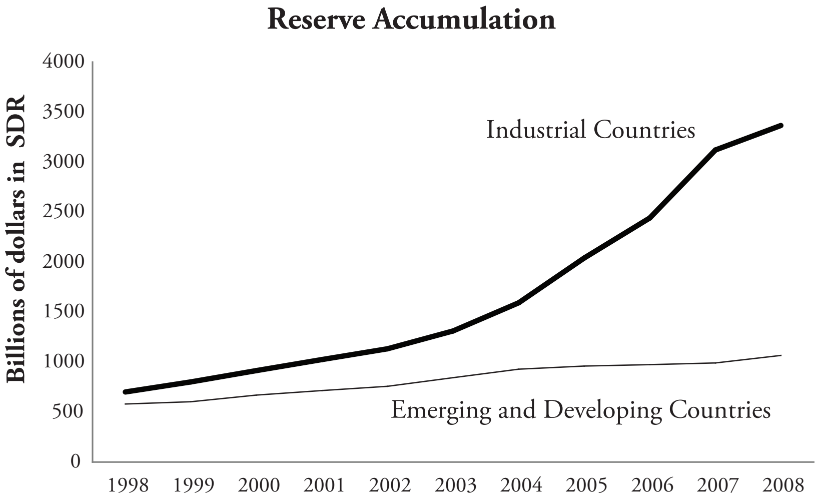
Well, the opposite of what was predicted happened. Exchange rates became more flexible, but as Figure 4 shows, developing countries accumulated more reserves than they had before. So why did this happen? It happened first, because the Mexican crisis and then the Asian crisis taught developing countries that sudden reversals in capital flows could be much more destabilizing than fluctuations in current account transactions. It is one thing to let an exchange rate depreciate gently in order to correct, say, a one or two percent of GDP exogenous shock to the current account. It is another thing altogether to deal with a capital flow reversal that could amount to 10 percent or more of GDP.[8]

But there is a second reason behind the strong surge in the demand for reserves. Financial-sector crises accompanied the balance of payments crises. Abrupt changes in exchange rates have repeatedly led to capital losses in banks

7. On external vulnerability and why exchange rate flexibility did not at all reduce the demand for reserves, see for example various chapters in Caballero, Calderon, and Felipe Cespedes, *External Vulnerability and Preventive Policies.*

8. Thailand experienced a private capital flow reversal of 12 percent of GDP between 1996 and 1997. In Turkey the reversal was 19 percent between 2000 and 2001, to give two of the more striking examples (Source: The Institute of International Finance, "Capital Flows to Emerging Market Economies.") Net private capital flows declined by many percentage points of GDP again, during the current economic crisis, in many Eastern European and some Latin American countries.

Figure 4



Source: IMF, International Financial Statistics

that had currency mismatches on their balance sheets and to, therefore, large recapitalization needs. Strong central bank reserve holdings help governments recapitalize banks, as these reserves are a source of strength of the consolidated public sector balance sheet, providing governments with greater flexibility and better access to capital markets.

To sum up: countries that cannot print large amounts of money without a collapse in its value need hard currency reserves whether or not their exchange rate is floating.

This second reason linked to financial-sector needs still reflects a precautionary motive. There is also a different, mercantilist motive for countries to accumulate reserves when they want to stimulate demand for their exports. The total demand for reserves and their increase reflects both the precautionary and the mercantilist motives, and it is difficult to apportion the total demand between these two sources. This paper concentrates on the precautionary motive, which

has been strong, but it was not the only reason for the huge reserve accumulation we have witnessed.

A key question relating to the future of the IMF is whether or not it can gain more of the features of a world central bank and become a reliable source of precautionary finance for member countries. If the IMF were able to lend to member countries' central banks, as national central banks lend to banks incorporated in their jurisdictions, the excessive demand for reserves we have witnessed would no longer be justified. In such a world, countries could regard their membership in the IMF as allowing them to access reserves in case of need. This would give the IMF a long-term financial role, beyond the immediate one of lending emergency resources borrowed from selected countries. The recent G-20 meeting convened in London gave the IMF the role of channeling emergency finance. That role may be necessary and desirable in the short term, but it does not give the IMF a stable long-run function that is not dependent on ad hoc political scrambling of the type we are witnessing in 2009.

How could the IMF start to function as a true lender of last resort and a source of precautionary finance? First, we must ask how adequate resources can be generated to allow the IMF to play that role. The best way to create sufficient resources would be to decide on a large up-front quota increase to be followed by regular quota increases and to change the modalities of access to IMF resources to make them into truly precautionary resources.[9] Every qualifying country would have to have automatic access to IMF resources, well beyond its reserve share, up to a certain multiple of its quota, with an interest charge that would increase with the amount of use.

9. Currently, countries are required to make one-quarter of their quota-subscription payments in either SDRs (Special Drawing Rights) or widely accepted currencies such as the U.S. dollar, the euro, the yen, or the pound sterling. The remainder can be made in their own currency. Some have suggested that the "hard currency" percentage be reduced or abolished. While this would help the poorest countries, it would also reduce the overall ability of the IMF to lend, since it lends hard currencies. Source: Factsheet, IMF Quotas (International Monetary Fund, August 31, 2009), http://www.imf.org/external/np/exr/facts/quotas.htm.

Table 1

	Current Quota	*Proposed Quota*	*Proposed Resources*	*2007 Reserves*	*Proposed Resources*	
	Billions of SDR				*Percentage of 2007 Reserves*	*Percentage of 2007 GDP*
Brazil	3.0	4.3	38.3	113.6	33.7	4.5
China	8.1	9.5	85.7	969.1	8.8	4.0
India	4.2	5.8	52.4	169.4	30.9	7.5
Mexico	3.2	3.6	32.6	55.1	59.2	5.0
South Africa	1.9	1.9	16.8	18.9	89.1	9.4
Turkey	1.2	1.5	13.1	46.6	28.1	3.2

To illustrate the order of magnitudes involved, if quotas triple, resources worth three times the Brazilian quota would amount to 4.5 percent of GDP (assuming the April 2008 amendment passes). As Table 1 shows, multiplying the April 2008 quotas by nine, as access ceilings, would translate into 4 percent of 2007 GDP for China,[10] 7.5 percent for India, 5.0 percent for Mexico, 9.4 percent for South Africa and 3.2 percent for Turkey. These are probably the orders of magnitude involving access to resources that would qualitatively transform the IMF into a lender of last resort and substantially reduce the demand for very large national reserves. While such resources would still not cover the kind of capital flow reversals that have at times been observed, the very existence of this precautionary finance would reduce the excessive volatility of capital flows by reducing risk.

Lending resources to the IMF under the NAB (New Agreement to Borrow) is not a good substitute for quota increases. The G-20 proposed that mechanism in London, and given the urgency of mobilizing resources to fight the crisis, there seemed to be no other choice. But in fact, the U.S. Congress has been slow in approving the U.S. contribution.[11] And while there has been progress with

10. Clearly, the size of China's reserves means that there is no need for China to access precautionary IMF finance. Nonetheless, China is included in the table to provide context.

11. When this paper was first drafted, the contribution had not yet been approved. As of this writing, the bill has passed Congress and awaits the president's signature.

China on an agreement whereby China would buy an IMF bond denominated in Special Drawing Rights (SDRs), the IMF is still well short of the resources announced at the G-20 meeting. The NAB does not provide automatic burden sharing and currently requires repayment after five years. It does not lead to a permanent availability of precautionary resources that would grow with the expansion of the world economy. That would be much better achieved by periodic increases in quotas with the participation of all members of the IMF.

For such a system to work as a mutual insurance mechanism that countries would trust,[12] access to precautionary IMF resources has to be *immediate* and *predictable* within reasonably high ceilings, falling broadly into the four to nine percent range of GDP referred to above. On the other hand, like with all insurance schemes, participating members would have to fulfill certain ongoing conditions. Conditionality would not restrict the access of a member in good standing, but it would require the member to be in good standing at the time of the request. That kind of *ongoing conditionality*—let us call it *adherence to a pre-agreed code of conduct*—cannot be avoided.[13]

To some extent, the IMF's new Flexible Credit Line (FCL) has essential features of a truly precautionary facility.[14] It is large, providing Mexico, for example, with $47 billion,[15] which is close to 5 percent of Mexican GDP and 61 percent of Mexican reserves as of April 2009.[16] It has been made available unconditionally because Mexico was considered to be in good standing.[17]

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12. My Brookings colleague, Eswar Prasad, had proposed a mutual insurance scheme, outside the IMF, fearing that the stigma and governance issues plaguing the IMF would be too difficult to overcome. See Prasad, "The Insurance Solution."

13. Substantial automatic access without any reference to pre-qualifying conditions, sometimes called for by well-intentioned progressive critics of the current system, would create massive moral-hazard problems and could lead to large bail-outs of governments with irresponsible policies at the expense of all other members.

14. "IMF Overhauls Lending Framework," International Monetary Fund Press Release No. 09/85, March 24, 2009, http://www.imf.org/external/np/sec/pr/2009/pr0985.htm.

15. "IMF Approves $47 Billion Credit Line for Mexico," *IMF Survey Magazine,* April 17, 2009, http://www.imf.org/external/pubs/ft/survey/so/2009/car041709a.htm.

16. For reserves, source is Bank of Mexico. At the end of April 2009, Mexico had $76.8 billion in international reserves.

17. Not all IMF finance would be precautionary. There will always be room for what we can

For such a system to be generalized, however, there are several further requirements. First, the code of conduct that allows pre-qualification must be clear, non-arbitrary, and broadly acceptable. It should allow policy space to member countries without imposing too narrow a conception of what is or is not good economic policy. The IMF has made too many mistakes in policy evaluations in the past to be able to claim that its views on a particular set of circumstances are to be accepted as uniquely correct. It is noteworthy, for example, that the Baltic countries, which were held up as poster children until the recent crisis, are today precisely the countries that have been hit hardest by the crisis. So some modesty is in order and some diversity in policies should be perfectly acceptable. Note that this appeal to modesty should not be interpreted as particularly critical of the IMF: many others have made mistakes. Economists in general should not think of themselves as infallible and differences of view should be considered as normal and healthy.

This call for "policy space" does not mean that any set of policies should be acceptable and pre-qualified. There will remain a need for professional evaluation and, therefore, the decision-making mechanism relating to the evaluation of conduct must be perceived as non-political, competent, transparent, and legitimate. In this context, one should note that it is not completely clear what currently pre-qualifies a country for the FCL. The IMF documentation leaves much subject to judgment:

> [Qualification depends on] an assessment that the member (a) has very strong economic fundamentals and institutional policy frameworks; (b) is implementing—and has a sustained track record of implementing—very strong policies, and (c) remains committed to maintaining such policies in the future. The relevant criteria for the purposes of assessing qualification for an FCL arrangement include: (i) a sustainable external position; (ii) a capital account position dominated by private flows; (iii) a track record of steady sovereign ac-

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call "work-out" finance for countries that face particularly difficult circumstances or policies that require major reforms.

> cess to international capital markets at favorable terms; (iv) a reserve position that is relatively comfortable when the FCL is requested on a precautionary basis; (v) sound public finances, including a sustainable public debt position; (vi) low and stable inflation, in the context of a sound monetary and exchange rate policy framework; (vii) the absence of bank solvency problems that pose an immediate threat of a systemic banking crisis; (viii) effective financial-sector supervision; and (ix) data transparency and integrity. Strong performance against all these criteria would not be necessary to secure qualification under the FCL, as compensating factors, including corrective policy measures under way, would be taken into account in the qualification process.[18]

While all areas referred to above are valid areas of concern and analysis, it is clear that a huge amount will be left to judgment. What is "sustainable," "comfortable," or "effective"? It is also interesting to note that there is no explicit reference to a country's track record in generating rapid growth in the above criteria. Maybe a country's track record on generating growth will be considered as part of what determines "sustainability," but while other factors are explicitly mentioned, growth is not. Be that as it may, there will naturally always be some role for judgment by IMF staff and management to be endorsed by the governing body. That is why governance reform, including the correction of the under-representation of many developing countries and the over-representation of European countries, is critical to the acceptance of IMF finance as "acceptable" precautionary finance. Decisions made by the governing body must be very broadly acceptable.[19]

A third major aspect of the reform that is needed has to do with the way reserves are accumulated and held. It is true that the original Triffin dilemma no longer exists.[20] The disappearance of the fixed link between the dollar and gold

18. "IMF Overhauls Lending Framework" (see n. 15).
19. Derviş, *A Better Globalization*.
20. Under the original Bretton Woods system, if the United States provided sufficient liquidity

means that, if a country does not accumulate reserves by running a current account surplus, reserves can be borrowed without gold acting as a constraint on their supply—at a price! It remains true, nonetheless, that if countries want to accumulate dollar reserves, the United States must supply them, either through a current account or capital account deficit, that is, it must run an overall balance of payments deficit.[21]

The accumulation of global imbalances over the last decade has led to renewed demand for a fundamental change in the international reserve system.[22] If SDRs could be "created" regularly and allocated to countries as reserves, there would be less need for the creation of reserves through a U.S. balance of payments deficit, and the desire for reserves would not lead to global payments imbalances. It would also be possible to link the amount of SDRs created at a particular time to world economic conditions—create more if there are deflationary conditions, create less if there are inflationary pressures. If one accepts this reasoning, as well as the previous arguments for greater amounts of precautionary finance, it is natural to argue for a system where part of the quota increases could be financed by the creation of SDRs. Quotas of member countries would increase as they receive additional SDR allocations. In such a system, a greater share of IMF resources would take the form of SDRs and, indeed, there would be no need for the distinction between the General and SDR accounts.[23] It is in fact this kind of system that was broadly envisioned when the SDRs were created in 1969. Let us look at how William McChesney

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by running a current account deficit then there would eventually be a crisis of confidence when the supply of dollars exceeded the supply of gold. However, if the United States stopped running a current account deficit then there would not be sufficient liquidity. See Triffin, *Gold and the Dollar Crisis*.

21. Note that supplying these dollar reserves by running a current account deficit increases the U.S. net debt position, whereas supplying these through the capital account does not.

22. See for example Stiglitz, "Commission of Experts"; Ocampo, "The Instability and Inequities of the Global Reserve System"; and Williamson, "Understanding Special Drawing Rights."

23. When SDRs were created countries did not want the General and SDR accounts to commingle for fear that the SDR "experiment" would fail. Since currently each account has a cap on the obligations that members have to the Fund, combining them would provide more discretion in how members' obligations are fulfilled (e.g. a given country could have more obligation to convert SDRs to hard currency and less to lend). For more detail see Polak, "Streamlining the Financial Structure," and Ocampo, "Instability and Inequities."

Martin, Federal Reserve Chairman from 1951 to 1970, viewed the SDRs and the IMF in 1970.

> Perhaps the most dramatic development to date in the process of evolution to a world central bank is the agreement to create Special Drawing Rights. Under it, international money is now being created deliberately and systematically and through a process of multilateral decision making. In this aspect the Fund is serving as a central bank to the monetary authorities of the countries that make up its membership. . . . In the future, the U.S. balance of payments should no longer be, as it has been in the past, a major source of growth in world reserves.[24]

Note that these words were those of the former *American* chairman of the Federal Reserve. Contrast this expression of enthusiasm with the fact that the United States has blocked the 1997 IMF Board of Governors decision to issue a very modest amount of SDRs—$32 billion (21.4 billion SDR[25])—for more than a decade! One hundred thirty-one members representing more than 77 percent of voting power approved it long ago. The April 2 G-20 agreement to propose the creation of $250 billion worth of SDRs, compared to the $32 billion in existence and the $32 billion pending U.S. approval since the 1997 “fourth amendment” decision, is therefore truly revolutionary. Note that it does not need formal U.S. congressional approval because it is an allocation strictly in proportion to existing quotas, contrary to the 1997 proposal that tries to allocate a greater-than-proportional share to the Eastern European countries because they had not participated in the earlier 1969 and 1979 allocations. In practice, however, at least tacit congressional approval is being sought by the Obama administration for the $250 billion new allocation.[26]

24. Martin, “Toward a World Central Bank?”
25. “Factsheet: Special Drawing Rights (SDRs),” *International Monetary Fund*, August 27, 2009, http://www.imf.org/external/np/exr/facts/sdr.htm.
26. By law, the administration is required to consult Congress 90 days before voting in favor of the allocation.

If the pending fourth amendment allocation of $32 billion and the new $250 billion allocation is approved and then followed periodically and regularly by significant further allocations, the current dollar-based international reserve system could gradually be replaced by a system where the SDR would be a major—but not the only— global reserve asset and wherein the IMF would acquire stronger features of a world central bank. The transformation would be more complete if the SDR allocations automatically led to quota increases.

The World Bank, Development Finance, and SDRs

The major increase in the availability of precautionary short-term finance through a much larger IMF described above would benefit developing countries by reducing the resource cost of excessive reserve accumulation and by allowing better countercyclical macroeconomic management. Achieving the growth of IMF precautionary resources through periodic allocations of SDRs would also benefit the world economy as a whole by facilitating the unwinding of the huge global imbalance that was due to the large U.S. current account deficit reflecting in part the strong desire to accumulate dollar reserves by some major developing countries. A more SDR-based reserve system would reduce the tension between wanting more reserves *and* smaller payments imbalances.

While a larger IMF financed by a major increase in quotas would augment resources available for long-term development by allowing less reliance on excessive reserve accumulation, it would not substantially alter what Ocampo calls the "equity bias" of the present reserve system, which is characterized by a situation where the richest countries receive the "seigniorage" revenues due to their ability to issue reserve money at almost no cost which other poorer countries pay for with real resources.[27] This "distribution of seignioriage" problem would be reduced, but would not disappear, if there were increased SDR allocation or if the increase in quotas were to be financed by such SDR allocations, because the existing rules governing SDR allocations distribute them

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27. See Ocampo, "Instability and Inequities," and Williamson, "Understanding Special Drawing Rights."

to countries in proportion to their quotas.[28] Rich countries would therefore get the lion's share of SDRs. Many see a reformed system of *SDR allocations* as a solution to this "equity bias."[29] Emerging and developing countries would either receive a larger share of the allocations or rich countries would agree to "donate" at least some of their SDRs to poorer countries according to some formula. If this were to become possible, the distribution of reserves would be altered "at the source," leading to a significant reduction of the equity bias.

It is important to stress, however, that even in such a reformed system, another part of the existing rules still limits the extent to which one should view SDRs as interchangeable with hard currency reserves. At present, a country that wants to use its SDRs actually has to exchange them for some hard currency and then pay interest to the provider of that hard currency. So there is no direct seignioriage equivalent to the printing of money involved in the allocation of SDRs but only more or less immediate access to a low-interest hard-currency loan.

Indirectly, it can be argued that an additional allocation of SDRs frees other reserves that can be used directly to purchase goods and services—and in that sense only, SDR creation does provide "free" real resources.[30] Ever since SDRs first appeared there have been proposals to use the direct or indirect seignior-age implicit in this creation of "quasi-money" at a global scale for development purposes or to finance global public goods.[31]

In my CGD book,[32] I had proposed the creation of a "Stability and Growth Facility" that would provide long-term predictable development finance to de-

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28. Developing and emerging countries will receive 32 percent of the proposed new $250 billion SDR allocation if it is approved.

29. See Ocampo, "Instability and Inequities."

30. The more "usable" and "liquid" SDRs become, the more they will resemble a reserve currency. One idea in that context would be to increase the number and kind of institutions that can hold them and use them, and in particular allow large private financial institutions to hold SDR deposits to meet their reserve requirements. I am indebted to Hamid Rachid of UNDP for this suggestion.

31. See, for example, Park, "The Link Between Special Drawing Rights and Development Finance."

32. Derviş, *A Better Globalization*

veloping countries. Nancy Birdsall liked the idea and we developed it further together in 2006.[33] Given the state of turmoil the World Bank was in at the time, we were not sure about *where* that facility should be "housed"—at the IMF or the World Bank. It is now clear to me that it should be housed at the World Bank, with regional versions of it in the regional development banks.

The fundamental rationale behind this proposed facility was twofold. First, there is a need for stable, countercyclical long-term development finance that would not be easily affected by the ups and downs of private capital flows. The crisis of 2008 and 2009 illustrates this need dramatically. Private capital flows to emerging market countries have fallen from $929 billion in 2007 to $466 billion in 2008 and are projected to fall further to $165 billion in 2009.[34] Over two years, that would be a decline of $764 billion.[35] The ramping up of MDB lending proposed in London is thus perfectly justified and illustrates the need Nancy and I had pointed to three years ago. Much more stable and predictable flows of long-term investment finance are needed by the developing countries. Private capital is central and crucial—but it can and should be supplemented by public resources that can leverage it and crowd it in during normal times, and compensate for it at times of turmoil.

There was a second component in the idea proposed in my CGD book, however: not only is there need for stability in the flows of development finance, but there is also an argument for some degree of concessionality, even in middle-income countries. The argument for partial concessionality has two dimensions. First, over half of the poorest people in the world still live in lower-middle-income countries.[36] The ethical and political foundations for the "all-or-nothing approach" to concessionality have never been very convincing.

33. See Derviş and Birdsall, "A Stability and Social Investment Facility."

34. Institute for International Finance, "Capital Flows to Emerging Markets." Emerging markets are Algeria, Argentina, Brazil, Bulgaria, Chile, China, Colombia, Czech Republic, Ecuador, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Romania, Russia, South Africa, Thailand, Tunisia, Turkey, Ukraine, and Venezuela.

35. Williamson, "Understanding Special Drawing Rights."

36. Source: World Bank, Poverty Calculator. Poverty is defined as $1.25 a day on a PPP basis. The precise number is 54 percent.

I had noted that in the current system, countries with incomes below a rather arbitrary cut-off point get outright grants or highly concessional loans, while other slightly less poor countries, where nonetheless there are huge numbers of very poor people, can only borrow at commercial terms.[37] Second, there is the need to finance global public goods. Take the development of cleaner energy resources in India or programs that help preserve the rain forests in Brazil or Indonesia, for example. There are huge global benefits to such programs, and the whole debate on carbon emissions and the financing of mitigation acknowledges very clearly that it would be unfair, and indeed politically infeasible, to ask such middle-income countries to bear the whole domestic cost of providing such global public goods. I had proposed, therefore, that the Stability and Growth Facility be somewhat concessional and include an element of "blending," with the interest rate being somewhat below the cost of commercial funds.

The Facility would thus have two characteristics: it would provide steady, long-run development finance, unaffected by cyclical variations in private capital flows, and it would include some degree of concessionality, justified both on purely distributional grounds (large number of very poor people) and on grounds of having to finance global public goods.

The current crisis has greatly increased the demand for World Bank and Regional Development Bank lending (the World Bank and the regional development banks together constitute the Multilateral Development Bank system, MDBs). But will there be a substantial financial role for the MDBs after the crisis? I believe there can be, provided the rich countries agree to such a modest amount of "blending" that would allow the cost of MDB loans to include an element of concessionality. The degree could vary with income level. One development worldwide that has greatly strengthened and rendered more visible the argument for an element of concessionality in MDB lending is the need to fight climate change. Helping Brazil preserve its rainforest has direct

37. There is some de facto blending during transition periods, but the dichotomy is essentially complete.

impact on global warming and should be seen as financing a global public good. The same can be said about helping India or China develop cleaner sources of energy. A World Bank lending instrument that explicitly recognizes these rationales and makes long-term development finance available at somewhat concessional terms to finance the incremental cost of physical and social infrastructure contributing to the provision of global public goods would give the World Bank (and the regional MDBs) a long-term robust role beyond the immediate but hopefully temporary financial crunch due to the current crisis.

One way to finance such long-term lending by the MDBs could be to have the IMF buy MDB bonds and to allow it to do this, partly at least, by using some of the SDRs that would be donated by rich countries. The mechanism envisioned would allow the MDBs to access IMF resources below market cost and on-lend them also below market cost. Both the fight against extreme poverty and the provision of global public goods could thus be financed partly by the seigniorage revenues generated by the creation of international reserves.[38] The fact that it would be the World Bank and the regional development banks managing these programs would help to not mix roles and would preserve the macroeconomic and monetary nature of the IMF. The use of SDRs would simply provide a ready *burden sharing* formula and lead to the participation of all rich countries in the financing of these programs. While the amount of SDRs donated could vary by country, a constant proportion-of-quota rule would have the added advantage of linking what countries contribute to global public goods to their share of influence in the governance of the IMF.

This is, of course, only one way to blend concessional resources with commercial resources in World Bank and regional development bank lending. It has advantages and disadvantages compared to other approaches to blending. But as discussion of the potential role of SDRs in the world economy increases, it is an approach that should be considered seriously.

38. George Soros has long pushed for a greater role for SDRs in international aid. See for example *George Soros on Globalization*.

The argument for using or not using SDRs in such a way is separate from the argument for blending in itself. There are many who have objected and will continue to object to blending in World Bank lending. This is somewhat odd, as the need for blending is recognized and illustrated by the multitude of trust funds established by donors and housed at the World Bank. These trust funds take the form of grants, and a good part of these resources do benefit not only the low-income countries but also the lower-middle-income countries.

What is proposed here is another way of fighting extreme poverty and of financing global public goods that could complement and perhaps replace some of these complex, costly, ill-coordinated, and often inefficient efforts. The principle that a greater amount of seigniorage revenue should accrue to the world as a whole, rather than the richest countries alone, would seem to be easy to accept. Indeed it would seem to be more compelling than other "innovative financing" mechanisms, such as the tax on airline tickets which fall on one particular sector. An SDR-based mechanism channeled through the MDBs would be comprehensive, depoliticized, and multilateral. Once implemented the transaction costs would be small and it would give the World Bank and the regional development banks a strong ongoing role beyond the immediate crisis period we are currently in. While important, the amount of resources that could be lent through such a blending mechanism would be limited, with plenty of scope for purely commercial lending to expand.

The key point is that commercial lending alone cannot address the central need to finance global public goods. Nor is it the best vehicle to fight extreme poverty. Finally, while blending would have a component that is similar to foreign aid, it could be embedded in investment financing that also has many features of private investment. It could and should be used to leverage private flows both in fighting poverty and in financing global public goods.

Conclusion

Full-scale adoption of something close to the proposals outlined in this lecture, admittedly, faces formidable obstacles. The fact that even the much more modest reform proposals that have been on the table over the last few years, that received new support and were expanded at the G-20 meeting in London, are having great difficulty gaining legislative approval is very troubling. If the new multilateralism that many leaders are appealing to is to translate into reality, non-marginal action is required. The world economy almost fell into a deep depression. It still faces formidable obstacles on the road to a real recovery. Unemployment in 2009–2010 threatens to reach the highest levels in decades and could be persistent. Tens of millions of people have been thrown back into extreme poverty. Climate change poses a formidable challenge to our long-term prosperity and well-being. The crisis has demonstrated the need for strong collective action. The Bretton Woods institutions have been thrust to center stage. Perhaps a clear, consistent, and comprehensive articulation of an ambitious reform agenda today has a better chance of being heard and could be translated into political action. It is certainly a time to try very hard to provide a vision for the collective actions that almost everyone agrees are needed, but that seem to be so difficult to organize in concrete and feasible ways.[39] It may be that it is too much marginalism itself that is part of the problem and that a big discrete step forward—certainly very challenging—could be nonetheless easier than a hundred small steps that all get bogged down. It is after all such a big step that led to the creation of the Bretton Woods institutions in the first place.

39. See, for example, Eichengreen, "Out of the Box Thoughts."

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