The Impact of the IMF: Economic Stability or Moral Hazard?

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Thank you Chairman Huizenga and Ranking Member Moore for inviting me to testify today on the International Monetary Fund (IMF). During my 14 years at the IMF I represented three Administrations, nominated first by President Clinton and subsequently by President Bush. I continued serving as United States Executive Director representing President Obama until last year. I am currently a Public Policy Fellow at the Woodrow Wilson Center. My testimony today reflects my personal views, not those of the Wilson Center.

During my years at the IMF the global economy generated strong growth up until the global financial crisis erupted several years ago. The United States led the recovery from that crisis by taking forceful monetary and fiscal policy actions to stop the downward spiral in the United States and by advocating actions in the IMF supporting multilateral financing and adjustment programs in a number of crisis countries.

The International Monetary Fund was instrumental in helping many countries to return to economic stability and financial viability, thereby restoring access to private sector financing. The IMF's mission is to help countries with financing needs, and the IMF did this by designing policy adjustment programs and pooling financing from across its member countries. Thus the United States did not carry the full burden of providing financial support; instead almost 80% of financing came from other countries around the world. While the IMF was leading crisis resolution efforts in Europe and the Middle East, it also continued its important support for low income countries.

US leadership was crucial in bringing together all the elements needed for the IMF's international response. But that leadership is eroding as the United States loses status and influence due to US delays in approving the IMF quota and governance reforms agreed to in 2010.

IMF Quota and Governance Reform is in the US National Interest

The United States remains the largest economy in the world and has the largest single country vote in the International Monetary Fund, which gives the United States veto power over key decisions such as amending the IMF Articles of Agreement and increasing overall IMF financial resources.

Voting power at the IMF generally rests on a country's economic weight, yet current shares do not reflect the more rapid growth of many emerging market and developing countries. As a result, Belgium still has a larger quota share and vote than South Korea, Mexico, or Turkey.

The United States recognized this distribution of voting power was outdated and threatened to undermine the global legitimacy of the IMF. Beginning in 2006 the US Treasury Department proposed initial steps to realign quotas. IMF members reached a broader agreement in 2010 that would further change the distribution of voting shares to reflect the growth of dynamic emerging markets and developing countries. Since then progress has stalled as the world awaits US ratification.

In the meantime, the rest of the world is moving ahead with new regional and specialized financial institutions. Brazil, Russia, India, China and South Africa (BRICS) are forming a development bank, and now China is leading the formation of the Asian Infrastructure Investment Bank (AIIB), with many US allies already participating. The BRICS have also formed a Contingent Reserve Arrangement as a mutual balance of payments backstop.

US Role at the IMF

Today's hearing presents an opportunity to clarify many of the elements of the 2010 IMF quota and governance reform package.

First, the US share will remain comfortably above the 15% veto threshold. In fact, this 2010 agreement includes no change in the US financial commitment to the IMF. The increase in the US quota, or share, will be financed by an equal reduction in the US participation in the New Arrangements to Borrow (NAB), a line of credit the US and many others have provided the IMF. Importantly, this reform will reduce the overall share and voting power of Europe, while increasing that of dynamic emerging markets and sustaining the voting power of the poorest countries.

The US priority should be to recognize the rapid growth and development of the emerging markets. This would keep global economic policy-making centered in the International Monetary Fund, where the United States plays a leading role in setting standards of behavior and guidelines for international lending. With emerging markets generating larger shares of global growth, their contribution to and their stake in the multilateral system should be acknowledged. Approving the IMF reforms would demonstrate that and would help sustain emerging markets' commitment to this system.

Furthermore, countries that will benefit from higher quota shares include key allies of the United States such as Mexico, South Korea, Poland, and the Baltic nations – all countries supporting and demonstrating the benefits of economic reform and sharing US views on political and economic freedoms.

Second, some view the IMF view as an instrument of Europe and claim the IMF should not have rescued Eurozone countries. But without the IMF as the crisis manager in Europe, we risked the dissolution of the Eurozone as a growing crisis erupted in several Eurozone countries in 2010. If the Eurozone had fallen apart, the US dollar would have risen sharply on global markets as investors fled a disintegrating European currency union and sought the US safe haven, with negative effects on our economy. Our exports such as capital goods and our import competing industries such as autos would have felt the most direct effects. A collapsing Eurozone would have increased the risk of European bank failures, which would have affected US financial institutions and corporations as well as stock and bond markets. The US economic recovery would have been undercut.

Did the IMF ability to lend large amounts incentivize Eurozone countries to mismanage their finances and slide into crisis? That hardly seems likely, as evidenced by the very demanding policy adjustment programs that were put in place. Clearly, countries avoid turning to the IMF until no other option remains. And while some investors might seek high returns in higher risk countries thinking that IMF lending will finance their exit, those illusions should be dissipating as some countries resort to capital controls and others turn to debt restructurings.

What is clear is that IMF participation in these adjustment programs helped prevent a downward spiral. The European Union had not yet built its own defenses for Eurozone countries and thus could not quickly mobilize the financing needed to restore confidence and stabilize financial markets. Since then, Europe has made progress building its own firewalls and actions of the ECB have helped reduce these risks. But as current EU uncertainties show, significant challenges remain and longer-term solutions are needed. And as all countries remain entitled to turn to the IMF for assistance, IMF engagement in Europe, in one form or another, will likely continue. This spares the United States from making bilateral financial commitments to support key allies in Europe.

Third, over the many decades of the IMF's existence, US leadership has persuaded others to join in promoting reforms. The United States has been a leading voice for accountability, transparency, and change at both the institution itself and within member countries. US initiatives at the IMF have led to much more openness in government accounts, sounder financial institutions as countries improved regulatory oversight, reductions in the financing channels for money launderers and terrorists, and improved economic growth and stability in low income countries.

Important US national security priorities were supported by IMF lending programs and technical assistance for Iraq, Afghanistan, Tunisia, and Jordan. More recently the IMF responded to US calls to increase support for the Ebola-affected countries in Western Africa and to underpin the economic reforms in Ukraine with vital financing in the face of internal conflict and Russian economic pressure.

Sadly, US leadership continues to erode as the United States delays approval of the 2010 reforms. In my last months at the IMF it became increasingly clear that other countries had little enthusiasm for US proposals, such as extending the zero percent interest on low income country loans. And privately many of my IMF counterparts lamented a weakened United States, recognizing that over the years our many ideas had helped promote global growth and economic development.

How IMF Reforms are Adopted

It would be useful to explain how the IMF adopts new policies for its operations, whether to engage in more intensive examination of financial regulatory policies or to change how it imposes conditionality on its lending. Most IMF decisions, such as its conditions for lending or the focus of country macroeconomic analysis (surveillance), are taken by simple majority voting. The United States' voting power of between 16-17% of course helps in starting to build a supportive coalition. But the US needs much broader support to achieve success. That meant I would visit the 23 other Executive Directors to make the case for US proposals and to persuade my counterparts of the benefits to their countries of expanded IMF work on anti-money laundering and countering the financing of terrorism, or the merits of more rapid public release of IMF documents. Important IMF initiatives to support low income countries required the approval of many other countries, as they had to agree to the financing mechanisms. In the last year or so of my tenure, this became increasingly difficult, as my IMF counterparts would each cite their frustration with US delays in ratifying the 2010 reforms and remain noncommittal on my request.

Remaining Misconceptions

Some commentators claim the United States will lose its chair on the Executive Board if all Executive Directors are elected (currently the countries with the five largest quotas appoint their Executive Director (ED)). That is incorrect; the United States will *not* lose its seat on the Executive Board when all EDs are elected. The rules for ED elections are set by an 85% vote of the IMF membership; I am sure the US Governor for the IMF, the Treasury Secretary, would veto any rules that would prevent a US seat at the table.

Others express dismay at China's growing voting power. China does receive the largest share increase of any country with its voting share increasing from about 4% to 6%, yet its voting power will remain below its share of the global economy, as will India's. China will retain its single country chair, as will Russia and Saudi Arabia, but

Russia's voting share, once these reforms are enacted, will remain lower than it was before 2006. In comparison, the US voting share under these reforms will be about 16.5%, comfortably above the veto threshold.

IMF lending terms have been described as too generous, too long term, but that perception is outdated. As a result of reforms put in place in 2000, the IMF levies surcharges on its larger loans. Thus, the interest rates on these loans are much higher than market rates for countries in normal situations. This generates the incentive for countries to repay as quickly as possible, once their market borrowing rates have returned to more normal levels. Many countries have repaid early, including Ireland, Latvia, Iceland, Bulgaria, Philippines, Uruguay, Indonesia and Argentina. Historically countries have repaid the IMF before any other creditor. This policy has strengthened the revolving nature of IMF lending, enabling the IMF to meet future country needs.

Worries about the strength of the IMF balance sheet are also unwarranted. The IMF has a very strong balance sheet due to its own reserves and its gold holdings. To reassure all its members that the IMF is a sound institution it has built up its own reserves, now above $16 billion. In addition, the IMF holds over 90 million ounces of gold, with an unrealized market value of over $100 billion. This far exceeds the current outstanding lending of the IMF, about $75 billion, indicating that the IMF's overall financial health and therefore the US position in the IMF are well protected.

Financing Issues

The IMF currently has a backstop of numerous bilateral loan agreements with a subset of members. This does not include the United States; US commitments continue to be through the quota subscription and the NAB. The United States has veto power over NAB activation every six months (individual country programs have always been approved by a simple majority vote of the Executive Board). Other groupings of countries also have veto power over NAB activation, leaving the lingering concern that if the United States does not ratify the reforms strengthening the IMF's core capital, the IMF will continue to seek bilateral loans, negotiated with less transparency and without US involvement. Decisions on IMF financing should be made around the table with all IMF members represented.

In conclusion, I am honored to have represented the United States during three Administrations at a critically important global institution that has provided many benefits to our country and the global economy. The United States' commitment to this vital institution over the years has underpinned the US leadership role, going far beyond holding veto power over a few key decisions. Approval of the 2010 reforms would restore and sustain that leadership role.

Thank you.