The role of the IMF in a changing global landscape

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Testimony to US House of Representatives Committee on Financial Services, Sub-Committee on National Security, International Development, and Monetary Policy, Virtual Hearing on February 17, 2022.

The context

The Covid-19 pandemic has increased the inequalities between rich countries and the rest of the world (other than China). Most developing countries face a significantly worse external environment, and their resources are now even more constrained than before. This has already led to has led to declining employment, significant increases in poverty and hunger, and worsening economic prospects in the near future. This process reduces the expansion of global effective demand, which in turn limits the potential for global economic recovery.

One major reason for the K-shaped global recovery is the huge variation in fiscal responses between rich countries and the rest.[i] Although the COVID-19 pandemic caused government revenues to decline in all countries, the advanced economies increased their public spending and tax benefits in 2020 by around 18 per cent of GDP. The United States provided significantly more, as much as 25 per cent. By contrast, emerging-market economies provided less than 6 per cent and low-income countries only 2.5 per cent of their 2020 GDP.[ii] Because their income bases were already lower, developing countries as a group spent only a tiny fraction in per capita terms of what was spent in the advanced economies.

In 2021, even as fresh waves of COVID-19 infections were causing economic havoc, "fiscal consolidation" expressed as attempts to control and reduce public spending was already well underway in many middle and low-income countries, owing to the rising levels of public debt accrued over the previous two years, largely because of events beyond their control.[iii] This inevitably worsened their economic outlook, and prevented even essential public spending on nutrition and health services.

This is why the IMF's new SDR allocation of 2021 was greatly needed, is entirely consistent with the mission of the IMF, and is in the interests of both these countries as well as the United States. It is also why the functioning of the IMF needs to be changed to be able to cope with new and emerging global challenges.

The 2021 SDR allocation

In August 2021, the IMF issued $650 billion worth of its own liquidity, Special Drawing Rights (SDRs). Because SDRs are distributed according to countries' IMF quotas, low-income and middle-income countries received only around $250 billion, while rich countries got nearly $400 billion, most of which they are unlikely to use. Even so, the SDR allocation was a lifeline for several developing countries facing severe balance-of-payments problems, and helped to prevent further economic decline.

SDRs have several advantages over other types of international financing:

- They do not add to countries' external debt burdens, which is a major plus point given the increase in public and sovereign debt in most countries during the pandemic. Unlike loans from the IMF and other multilateral lenders, they are non-conditional. This makes them similar to the liquidity expansion automatically available to governments in some advanced economies like the US. They are designed to enable them to be used to strengthen the economy; they do not entail forcing countries to adopt measures like fiscal retrenchment that can damage or reverse the possibilities of economic recovery
- It enables them to be used without adopting measures like fiscal retrenchment that can damage or reverse the possibilities of economic recovery.
- SDRs are accessible to all countries, including middle-income economies that may face balance-of-payments constraints but are excluded from other multilateral funding. This is critical because most measures adopted by the international community in the wake of the Covid-19 crisis have been directed only to low-income countries, whereas there has been a widespread increase in poverty and economic distress across the developing world, including in some middle-income countries. A large fraction of the world's poorest people live in these countries, and they have limited resources with which to deal with the poverty within their borders.
- SDRs are virtually costless to use. The interest rate to be paid to the IMF is below 0.1 per cent, so they require only a tiny additional fiscal spending when they are used. Most significantly, they do not impose any costs on taxpayers in other countries.

It is difficult to think of an easier way to provide external finance to countries that urgently require it.

What is most significant for forex-constrained developing countries is that SDRs add to their external reserves *even if they are not used*. This can play an important part in stabilizing and providing some cushion to the balance of payments of recipient countries. These additional SDRs provide precautionary reserves that serve an important role because of the greater volatility of international financial markets,. The increase in forex reserves can also improve their chances of accessing other forms of finance and reducing borrowing costs of recipient countries.

Of course, these SDRs can also be directly used in various ways. Since August 2021, at least 80 countries have used SDRs for these purposes:[iv]

- 32 countries exchanged SDRs for hard currency to the tune of $11.6 billion, presumably for increasing imports.
- 55 countries used SDRs to pay their IMF dues for $6.5 billion, which reduced their debt burden and eased repayment concerns in general.
- 39 countries recorded SDRs in the government budget, equivalent to $31.6 billion, presumably to spend on vaccination, health care and other priorities.

The use of SDRs has been significantly higher than after the 2009 allocation, and it has been more varied, reflecting the flexibility that SDRs provide. This has been crucial for these countries to cope with what has otherwise been an extremely harsh external economic environment, although the amounts are still inadequate to meet the requirement. Most of these uses occurred within three months of the SDR allocation, showing how urgently these resources were required.

It should also be noted that SDR expansion was and remains a crucial measure, because other forms of IMF financing have recently been tightened. In December 2021, the IMF repealed almost all of the flexible access limits on funding that it had introduced during the pandemic, including under the Rapid Financing Instrument introduced in March 2020.[v] Yet the uneven K-shaped global recovery has meant that many countries remain in severe economic difficulties, which are likely to worsen as the US and other advanced economies move to tighten monetary policy.[vi] There are soon likely to be many more countries requiring some form of external liquidity assistance because of such global processes that are not of their own making.

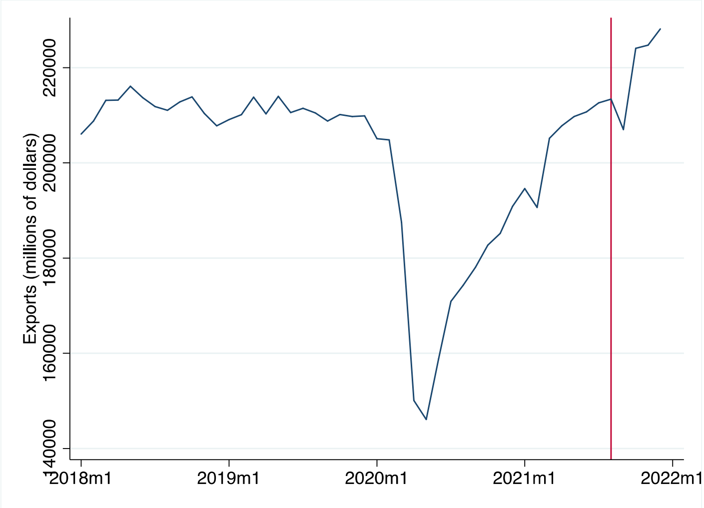
Impact on the global economy and on the US economy

While the amounts of SDRs utilized so far may appear to be small, they have still played a critical role for the economies that have used them, and even these small increases have mitigated to some extent the extreme increases in global fiscal inequality noted above. This is clearly of great benefit to these economies; which is clearly important for economic justice and reducing global inequality in general. It also has a positive impact in terms of increasing demand in the global economy, which is critical for a sustained and viable economic recovery even in rich countries. And it is also important for geostrategic reasons, serving to reduce international social and political tensions that could spill over with unpleasant consequences.

Indeed, the US economy is also likely to have benefited indirectly through this SDR expansion, because of a revival of its own exports to the rest of the world. Figure 1 shows the monthly pattern of US exports, which increased very sharply in late 2021 in the months after the new SDR allocation, when developing countries were able to access these additional resources. Obviously, many factors played a role in this increase in US exports, but the enlargement of fiscal space and easing of balance of payments difficulties among some previously very constrained trading partners was also important. The importance of a wider global recovery that includes developing countries, for the future expansion of US exports (with all of its income and employment effects in the US) should not be underestimated.

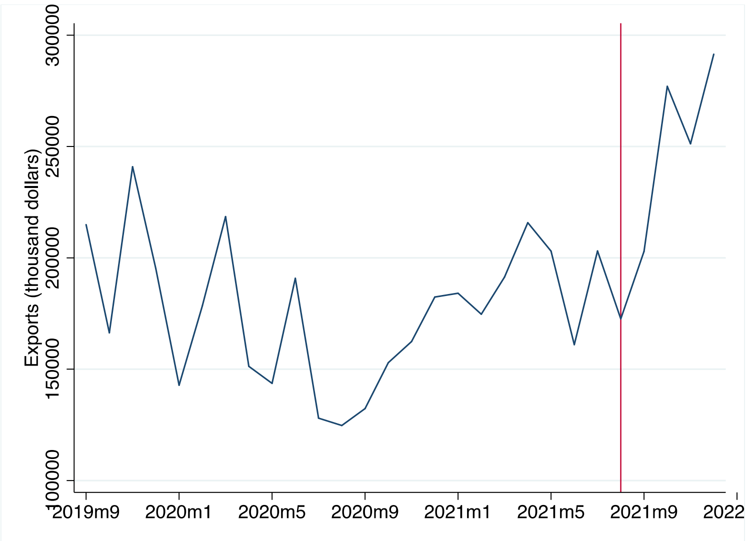
Figures 2-4 provides some examples of changes in US exports to emerging markets and developing countries. In Ukraine, which has been facing severe balance of payments problems well before the current military crisis, and had a very low level of foreign exchange reserves before the new allocation, SDRs were used to repay the IMF so as to reduce its aggregate debt burden, exchanged for hard currency with which it could engage in essential imports, and for increased public spending on covid relief as well as capital expenditure and to cover the deficit without taking on more debt. The importance of such measures for the governments and for the economy and people of Ukraine should be obvious. But it is worth noting that the SDRs issue also enabled Ukraine to increase its imports, and this was in turn associated with a dramatic increase in imports from the US from September 2021 onwards. Similar trends are evident for the Philippines and DR Congo, which also face severe balance of payments constraints. Therefore, in addition to helping the countries that use the SDRs, such imports clearly benefit exporting segments of the US economy.

Figure 1: Exports of the US, 2018-2021



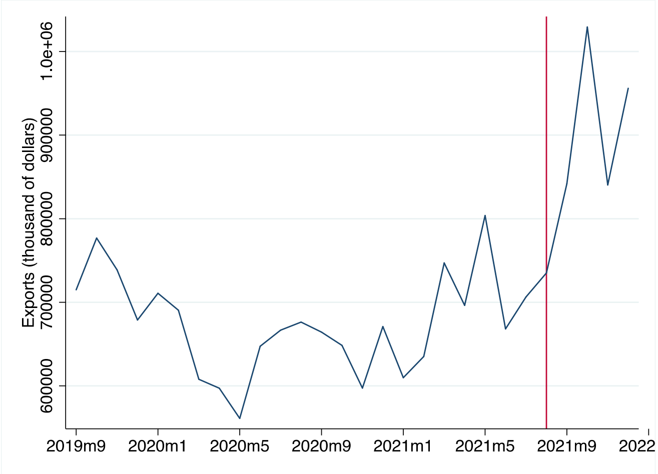
Source: U.S. Bureau of Economic Analysis

Figure 2: Exports of US to Ukraine, 2019-2021



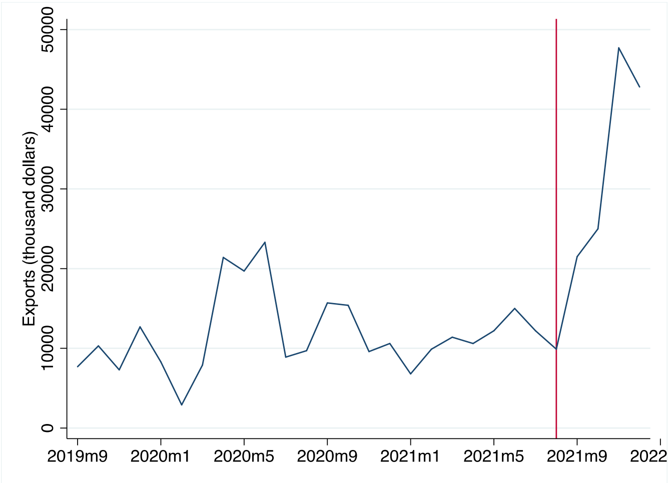
Source: U.S. Bureau of Economic Analysis

Figure 3: Exports of US to Philippines, 2019-2021



Source: U.S. Bureau of Economic Analysis

Figure 4: Exports of US to Democratic Republic of Congo, 2019-2021



Source: U.S. Bureau of Economic Analysis

There is therefore clearly a case for larger and more frequent SDR allocations. In addition to helping countries cope with the fallout of the pandemic, such allocations could be used to provide much needed climate finance to the developing world. It has been persuasively argued that an annual issuance of SDR 500 billion for a certain period could be provided to fund climate action.[vii] Such regular SDR allocations would provide essential resources to bolster mitigation and adaptation efforts in countries where they are most needed, in a context in which advanced economies have not yet fulfilled even their relatively modest pledge at COP15 in 2009 to mobilize $100 billion per year in climate finance for the developing world. In addition, the SDRs would provide some of the financing required to achieve the Sustainable Development Goals, which currently seem out of reach.

Concerns about SDR allocations

There is a concern that releasing so many SDRs into the global system would fuel global inflation, which is already seen as a concern. There are several arguments to be made against this position. First, the proposed sums for SDR expansion are trivial compared to the increase in liquidity of as much as $25 trillion fueled by the loose monetary policies in advanced economies since the 2008 global financial crisis.[viii] Total SDRs in the world toady amount to only $943 billion, which is just 7 per cent of the current global reserves of $12.8 trillion.[ix] Even if the share of SDRs in global reserves were limited to a certain proportion of international monetary reserves, say, 30-40 per cent, there is clearly significant scope for more issuance. Second, the SDRs allocated have rarely if ever been fully or even significantly used—most of the rich economies with global reserve currencies or surplus balance of payments positions find no need to draw on their SDR balances. Therefore, the actual liquidity released in the system tends to be a small fraction of the full new issuance. Third, there is a strong case for arguing that the current inflation is because of supply constraints and is cost-push determined, and should be handled accordingly. Therefore, attempts to use monetary restraint to control it would not address the root cause of the inflation even as they could damage prospects of recovery.

The other concern within some US policy circles is that SDRs could be used by countries currently facing US sanctions, allowing them access to foreign exchange and dollars in particular as a way out of the sanctions. But *none of the countries currently facing US sanctions of any kind (such as Iran, Russia and Syria) have used the new SDR allocation at all, largely because they are simply unable to do so* given the controls in international banking for any country that faces sanctions imposed by the Office of Foreign Assets Control (OFAC) of the US Treasury. In addition, the IMF does not recognize the governments of certain countries (such as Afghanistan, Myanmar, Sudan and Venezuela) and so they are also unable to use the SDRs that are listed in those countries' accounts. The question of whether such sanctions and lack of recognition are justified or even in the US' best interests is a separate and highly debatable matter; the point to note here is these governments are not able to utilize the SDRs even though they are formally available to them.

Recycling SDRs of rich countries that will not use them

There is a strong argument in favor of finding ways to use the $400 billion of SDRs allocated to rich countries that are unlikely to need them. While there are no costs to other countries if some countries do not utilize their additional SDR reserves, recycling SDRs could provide enormous benefits to the global economy, by enabling a more equitable and sustained recovery and causing a more widespread recovery of global demand.

As a result, how to recycle or re-channel existing SDRs has become an urgent question. The IMF's proposal to establish a $50 billion "Resilience and Sustainability Trust" (RST) is one attempt to recycle SDRs held by rich economies towards developing countries. However, the current plan for the RST would deprive developing countries of many of the advantages of SDRs. To begin with, the amount committed so far is very small, reflecting real lack of ambition. What is more, unlike SDRs themselves which are a debt-free asset, the resources are to be provided in the form of debt that must be repaid (albeit at low interest rates). In addition, they will be subject to IMF conditionalities that have far too often proved hugely counterproductive. The current plan limits the funds to be made available only to low-income countries or those currently under IMF programs, leaving out most of the developing world including the emerging markets. Overall, therefore, this proposal will at best have extremely limited impact, far too little to address the major financing challenges that currently exist. My comments, however, have suggested ways in which a Recycling Fund could easily be structured that would make it more effective. A large part of the funds channeled in this way should be debt-free, especially those provided to low income countries.

There are other means of recycling SDRs that should be considered. These should strive to maintain the features of SDRs that make them an attractive form of financing. That is, ideally they should be debt-free, accessible to middle incomes countries as well as low income countries, and include transparency and accountability safeguards on both providers and recipients. Conditionalities should not be of the kind traditionally associated with the IMF, but rather designed to ensure that the funds are used for urgent social and public helth purposes and for the climate transition.

One option is for rich countries to channel their SDRs to regional development banks, which are authorized to hold them. For example, institutions like the African Development Bank could use the SDRs to enlarge their capital base and provide developing countries with more climate finance and budgetary support for meeting the SDGs. Specifically for climate finance, there is a proposal (made by Avinash Persaud) to create a $500 billion per year climate finance trust, funded by SDR issuance. The trust would auction funds to countries, with auctions based not on monetary returns but on climate action: successful bids would be those that promise the greatest likely reduction of greenhouse-gas emissions resulting from the proposed investment. There are other ways of using recycled SDRs

It has been argued that such initiatives are not part of the remit of the IMF. But with the world economy facing such crucial challenges, it is important not to be stuck in older categories that may not be relevant to the current context. The need for all international institutions to cooperate is greater than ever, and the IMF can play a critical role in assisting such cooperation, specifically when there are major financial implications.

Some concerns with current IMF practices:

1. IMF Surcharges

One policy of the IMF that is currently counterproductive even in terms of its own goals is the practice of imposing surcharges on some debtor countries. While the IMF's base lending rate is low, it imposes a hefty surcharge on countries whose debt to the IMF exceeds a certain amount, or who have been in debt for more than four years. This punishes countries that the IMF chose to provide large loans to and makes it harder for them to grow out of their debt because of the higher interest costs they are forced to pay. It also reduces their ability to engage in essential public spending necessary to halt the pandemic and reduce its adverse impact. For example, Argentina will have to spend US $3.3 billion on surcharges from 2018 to 2023, which is 9 times what it would take to fully vaccinate every Argentine against COVID-19.[x] These surcharges are not just a problem for Argentina: the IMF's own estimates based on its WEO model suggest that "the number of surcharge-paying members would increase to 38 in FY 2024 and FY 2025, more than double the current level, and total surcharge income would increase by 50 percent".[xi] All of this income comes to an unfair redistribution from countries that are already facing extreme balance of payments difficulties to the IMF.

The surcharges have become an important source of revenue for the IMF: it is estimated to receive more than $4 billion in surcharges through end 2022, in addition to interest payments and fees. This amounts to nearly half of the revenue over this period, and indicates a significant increase in recent years, even though the IMF's own model makes it clear that it does not need this amount to add to its precautionary balances. These surcharges are hugely counterproductive for the countries that are forced to pay them, being imposed when they are already in distress and operating to worsen outcomes for both the borrowing country and its investors, affecting the government's ability to spend on essential services like health, on poverty reduction, and damaging economic prospects into the future.[xii]

The ostensible purpose of providing a disincentive for countries to keep borrowing from the IMF cannot be justified, given that all countries now seek to avoid borrowing from the IMF as much as possible, given the onerous conditionalities that are imposed. The costs to the country concerned and to the IMF's own presumed goals with respect to that country, far outweigh the monetary gains to the IMF, which are in any case unjustified. Individual countries cannot be blamed for receiving large loans, when it is the IMF that decides which country to lend to, the amount and the conditions of the loan. Similarly, surcharges cannot be justified as payment for risk: given the IMF's preferred creditor status, there are almost no defaults.

2. Continued emphasis on conditionalities involving fiscal austerity and regressive taxation in IMF programmes

The IMF continues to have double standards for some advanced and other countries on countercyclical spending and moves for fiscal austerity. The need for countercyclical macroeconomic policies is widely recognised in advanced economies, including the US; yet developing countries are forced to engage in procyclical policies. As a result, IMF programs impose policies on developing countries in balance of payments difficulties, that are not followed at all by the rich countries that are the major shareholders of the IMF. This was especially evident after the Global Financial Crisis of 2008-09[xiii], but remain true today. While the IMF leadership explicitly recognised the need for countercyclical spending during the pandemic, and some emergency financing avoided procyclical conditions, in general its programs on the ground typically continued to impose conditions that required very rapid fiscal consolidation (starting as early as 2021) and emphasised relying on regressive forms of taxation like VAT that disproportionately hit the poor.[xiv] The IMF's own review of its programs and conditionalities in 2018 noted that "Programs also appear to have systematically underestimated the impact of adjustment on growth. The regression analysis suggests that staff underestimated the growth impact of adjustment, both public and private".[xv]

3. Inadequate response to climate challenges

As the pre-eminent multilateral financing institution, the IMF has a major responsibility to recognise the significance of climate change and its macroeconomic, financial and developmental effects, and to work towards addressing climate challenges. This also requires a shift in its own monitoring and surveillance framework, to cover various types of climate risk including physical risk, transition risk, and spillover transition risk (resulting from climate policies of rich countries that hurt poor countries, such as a carbon tax with a carbon border adjustment mechanism that impacts hydrocarbon producers).[xvi] In addition, the IMF needs to be bolder in devising financing strategies for climate mitigation and adaptation efforts in the Global South, which are currently hugely underfunded. Since such investments fall in the realm of global public goods, it is important that they be dealt with in terms of global public investment, which the IMF (rather than the World Bank) can promote. Clearly, conditions for such finance need to move beyond conditional loans to grants that are based on climate response rather than the standard repayment requirements, particularly for low income countries.

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[i] See for example, Michael Spence, Joseph E. Stiglitz and Jayati Ghosh, "Avoiding a K-shaped recovery", Project Syndicate, March 24, 2021, https://www.project-syndicate.org/commentary/global-economy-avoiding-k-shaped-recovery-by-michael-spence-et-al-2021-03

[ii] IMF Fiscal Monitor April 2021, https://www.imf.org/en/Topics/imf-and-covid19/Fiscal-Policies-Database-in-Response-to-COVID-19

[iii] IMF Fiscal Monitor October 2021, https://www.imf.org/en/Publications/FM/Issues/2021/10/13/fiscal-monitor-october-2021

[iv] https://cepr.net/eighty-countries-have-already-used-their-special-drawing-rights-but-more-are-needed/

[v] Only the cumulative access limit (mainly for countries that already have an emergency loan and might need another one) for emergency financing was extended for another 18 months.

[vi] See, for example, the World Bank's World Development Report 2021.

[vii] Such a proposal was made by the prime minister of Barbados, Mia Amor Mottley At the United Nations Climate Change Conference (COP26) in Glasgow last November. https://euobserver.com/climate/153407

[viii] http://fingfx.thomsonreuters.com/gfx/rngs/GLOBAL-CENTRALBANKS/010041ZQ4B7/index.html

[ix] https://www.imf.org/en/Topics/special-drawing-right#:~:text=To%20date%2C%20a%20total%20of,on%20August%2023%2C%202021). https://data.imf.org/?sk=E6A5F467-C14B-4AA8-9F6D-5A09EC4E62A4

[x] https://cepr.net/report/imf-surcharges-counterproductive-and-unfair/?__cf_chl_jschl_tk__=pmd_ohhclqt9I0TSyDmjXlBPdWMaOdiRjPQmlXAsGl2owXQ-1633955388-0-gqNtZGzNAnujcnBszQgR

[xi] https://www.imf.org/-/media/Files/Publications/PP/2021/English/PPEA2021073.ashx

[xii] Joseph E Stiglitz and Kevin Gallagher, "Understanding the Consequences of IMF Surcharges: The Need for Reform" Policy Brief, https://www.bu.edu/gdp/2021/10/04/understanding-the-consequences-of-imf-surcharges-the-need-for-reform/

[xiii] https://www.bu.edu/gdp/2020/11/17/imf-austerity-since-the-global-financial-crisis-new-data-same-trend-and-similar-determinants/

[xiv] See, for example, Eurodad, "Arrested development: IMF lending and austerity post-Covid-19", chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/viewer.html?pdfurl=https%3A%2F%2Fd3n8a8pro7vhmx.cloudfront.net%2Feurodad%2Fpages%2F1063%2Fattachments%2Foriginal%2F1608122652%2Farrested-development-FINAL.pdf%3F1608122652&clen=264511&chunk=true;

[xv] https://www.imf.org/en/Publications/Policy-Papers/Issues/2019/05/20/2018-Review-of-Program-Design-and-Conditionality-46910

[xvi] Luma Ramos, Corinne Stephenson, Irene Monasterolo, Kevin P. Gallagher, "Climate Risk and IMF Surveillance Policy: A baseline analysis". chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/viewer.html?pdfurl=https%3A%2F%2Fwww.bu.edu%2Fgdp%2Ffiles%2F2021%2F04%2FGEGI_WP_047_FIN.pdf&clen=1654334&chunk=true