REPUBLICAN CAUCUS
THE COMMITTEE ON THE BUDGET
B-71 Cannon House Office Building
Washington, DC 20515
Representative Paul D. Ryan, *Ranking Republican*
Phone: (202)-226-7270
Fax: (202)-226-7174
Augustine T. Smythe, *Republican Staff Director*

THE ADMINISTRATION'S IMF PROPOSAL

3 June 2009

INTRODUCTION

Following its discussions and tentative agreements with the major industrialized and developing countries at April's G-20 meeting, the administration is requesting $108 billion in new funding and increased authority for the International Monetary Fund [IMF]. The request has been attached to an unrelated emergency war supplemental bill and appears to be on a fast track through Congress despite the important policy implications of the package.

The funding request comes at a time when the IMF stands at a crossroad as an institution. The international financial institution, created more than a half century ago in an era of fixed exchange rates, traditionally has focused on macroeconomic issues and international monetary stability. Its core mission was making loans to member countries experiencing short-term balance of payment difficulties, thus providing an important measure of stability in the international financial system. The IMF's traditional lending reached a historical low point just a few years ago, however, and it has been trying to adapt its focus, mission, and lending practices to the 21st century international financial landscape. In recent years, it has come to focus more on microeconomic and structural issues, which has sometimes blurred the lines between its activities and those of the development banks, namely the World Bank. But as its name implies, the IMF is a monetary authority, not a development agency, and it has clearly strayed from its original mission. The legislation currently before Congress would promote further "mission creep" at the Fund rather than maintaining its focus on macroeconomic policy.

This latest international financial crisis has seemingly given the IMF a new lease on life and a renewed sense of relevance. But the Fund's mission in the international financial system is still far from certain. Some key IMF members have suggested the institution should assume the role of global financial regulator, with powers to intervene directly in the domestic economies of member countries such as the United States. Countries such as China and Russia have recently said the IMF should become a global central bank and its currency, a synthetic composite of major global currencies, should one day supplant the dollar as the world's reserve currency. These moves would conflict sharply with U.S. national economic interests. Before the Congress grants the IMF an increase in funding and authority, it should have a clear sense of what role the institution will play in the world economy, and how its mission and actions may affect the U.S.

Clarifying the IMF's mission prior to new funding is particularly important now because the U.S. will have less control over IMF actions in the future, as other countries gain a greater voice inside the institution, and the Fund's managing director gains more autonomy. Earlier this year, one senior advisor to the Treasury Secretary publicly advocated that the IMF should lower, from 85 percent to 80 percent, its majority threshold vote for making policy decisions. This would essentially eliminate the U.S.'s effective veto power at the Fund.[1] More funding and less oversight is rarely a recipe for good outcomes, especially with regard to an international financial institution that seems to lack a clear mission and focus.

The Treasury Department has characterized the new IMF funding as a valid response to a global financial crisis. Although details of the IMF's future mission have not been fully sorted out, the administration has termed this an emergency, and urged Congress to tack this proposal onto a supplemental appropriations bill to gain quick enactment. But Congress has been down this road before, with the Troubled Assets Relief Program [TARP]. In response to a financial crisis, Congress gave Treasury the authority to address the emergency by purchasing distressed assets from financial institutions. The plan quickly changed, however, to the partial nationalization of the U.S. banking system by taking large equity stakes in key financial institutions. TARP funding also has been used for industrial policy purposes well beyond the scope of the original legislation – most recently to effectively nationalize most of the U.S. automobile industry.

While the Congress granted extraordinary authority to the TARP, it provided the authority was temporary and called for oversight by several entities (including a Special Inspector General, a Financial Stability Oversight Board, a Congressional Oversight Panel, and the Government Accountability Office). In addition, the agency that oversees the TARP – the Treasury – must seek annual appropriations from Congress. In contrast, the administration is proposing an indefinite ten-fold increase in the contribution to the IMF and an $11-billion "endowment" – meaning the IMF would have a permanent funding source for its operations, and expanded lending to low-income countries, all with little, if any, oversight from the U.S. Congress. The lesson from TARP is that Congress should consider the implications of new IMF funding and increased authority *before* passing the legislation.

This paper describes the key components of the IMF request and highlights some of the major policy concerns.

DESCRIPTION OF ADMINISTRATION'S IMF PROPOSAL

On 12 May 2009, the administration requested an increase in contributions and broadened authorities for the IMF, and is seeking to add this authority to the fiscal year 2009 war supplemental.[2] The administration's IMF proposal has four general parts, only two of which relate specifically to the headline dollar figure contained in the request.

Quota Increase

The plan would increase the United State's quota with the IMF by $8 billion. Quota subscriptions of member countries are the IMF's main source of funding. When a member country joins the

[1] http://www.voxeu.org/index.php?q=node/2896

[2] http://www.whitehouse.gov/omb/assets/budget_amendments/supplemental_05_12_091.pdf

IMF, it is given an initial quota, which relates to that country's economic size. The U.S. has the largest quota share, providing roughly 17 percent of all quota funding. (These shares also relate to each country's voting power and representation at the IMF.) Periodically, the IMF requests an increase in quotas essentially to keep its "core" resources in line with the size of the international economy. At the G-20 meeting, member countries tentatively agreed to an across-the-board quota increase. To keep the United State's representational share within the IMF constant (that is, at 17 percent), the U.S. needs to provide an additional $8 billion in quota funding. This quota increase represents a transfer of resources from the U.S. to the IMF. In return, the U.S. acquires an interest-bearing asset from the Fund, which is added to the U.S.'s foreign exchange reserves.

The quotas from member countries fund the IMF's "core" lending facilities. Historically, the majority of the IMF's assistance has been provided through Stand-by Arrangements [SBAs]. Repayment of SBA loans is typically due 3 years to 5 years after the disbursement is made. These loans have typically come with "conditions," meaning that borrowing countries have to show proof they are implementing suggested changes to their fiscal and macroeconomic policies.

The IMF has also recently launched its so-called Flexible Credit Line [FCL], which is for countries with relatively strong fundamentals and policies. FCL arrangements are approved for countries meeting pre-set qualification criteria. Unlike the SBAs, no policy conditions are attached to these loans. FCL loans typically last between 6 months and 12 months, and they can be tapped on a precautionary basis to prevent a crisis.

New Arrangements to Borrow

Although the IMF's core source of funding is through member subscription quotas, it also has developed "new arrangements to borrow," or NAB, as a supplementary funding source. The NAB is a credit arrangement between certain member nations (26 currently provide this funding) and the IMF that provides resources "to forestall or cope with an impairment of the international monetary system or deal with an exceptional situation." NAB resources currently amount to $50 billion, 20 percent of which ($10 billion) is provided by the U.S. At the most recent G-20 meeting, countries agreed to boost NAB resources tenfold, to $500 billion. The administration agreed to provide $100 billion in funding for the NAB, in line with its previous contribution share of 20 percent. This $100 billion of NAB funding is a potential obligation, and acts like a line of credit between the U.S. and the IMF. The money is not a direct transfer of resources to the IMF, like a quota subscription. When that line of credit is activated, the U.S. receives an interest-bearing asset from the IMF.

The catalyst for the substantial increase in the NAB is the global financial crisis and the impact it has had on emerging market economies. The NAB essentially represents a relatively quick, emergency line of credit for countries encountering temporary balance-of-payment difficulties due to global financial turmoil.

SDR Allocation Increase

One key under-reported element of the proposal is that it would allow the IMF to create significantly more special drawing rights, or SDRs. An SDR is a synthetic currency used by the

IMF as a unit of account. Countries receiving the SDRs can exchange this synthetic currency for the hard currencies of member countries, such as U.S. dollars, if they need to bolster their international reserve positions. In other words, by "creating" SDRs, the IMF is increasing the potential real money supply in the world when these SDRs are exchanged for hard currency. (SDRs are contingent liabilities of the U.S. government.)

The current SDR allocation spread among IMF member countries is roughly $32 billion, of which the U.S. has an allocation of roughly $5 billion to $6 billion. The proposal would boost this total SDR allocation by $250 billion. The U.S. would gain roughly $40 billion of this new SDR allocation, while the balance of the new SDRs would be allocated to other member countries in proportion to their financial representation in the IMF (i.e. their quotas).

By creating new SDRs, the IMF is essentially acting like a global central bank (an international version of the Federal Reserve), creating entirely new reserves that could be exchanged for hard currency in the international financial system. When the IMF creates SDRs and distributes them to member countries, it automatically bolsters a country's international balance sheet by creating more reserves. If a country experiences a financial shock, it can exchange its SDRs for a hard currency, such as U.S. dollars. (This exchange of SDRs for hard currency functions much like the U.S. federal funds market. The loans are typically short-term and interest is paid.) If a group of countries approaches the U.S. for such a loan, theoretically the U.S. Treasury would have to borrow to supply the dollars, or the Federal Reserve would have to print those dollars.

Note that this SDR allocation is separate in concept from member country subscription quotas, which (somewhat confusingly) also are represented in SDR amounts. The SDR allocation is the creation of new reserves by the IMF, while the subscription quotas represent tangible payments from member countries to the IMF to support core lending activities.

IMF Gold Sales and the IMF Budget

Due to its lack of lending activity in recent years (on which it makes money), the IMF has faced problems funding its operating expenses. The lack of income has forced the IMF to limit the immense growth in its budget, and to propose restraining the budget going forward. On behalf of the IMF, the administration is seeking authority allowing it to approve an IMF proposal to sell 12.9 million ounces of its gold holdings, which would generate an $11.6-billion "endowment." The IMF holds 103.4 million ounces of gold, the world's third largest official stock. Nearly half that amount – 47.9 million ounces – was originally contributed by the U.S.

The IMF budget amounts to nearly $1 billion annually, more than a three-fold increase since 1989. The IMF has a staff of about 3,000, which has grown by more than 50 percent during this same period.

In the past, there have been concerns about IMF transparency, mission creep, and oversight. By granting large increases in the IMF's quota, the NAB, and a permanent funding source for its budget and aid to other countries, Congress is giving tremendous discretion to the administration and the IMF.

Part of this endowment also would be used to support the IMF's so-called "concessional" lending to lower-income and highly-indebted poor countries. This lending appears far removed from the

IMF's core mission, and borders on the development aid already offered by agencies such as the World Bank. This measure seems to blur the line between "loans" and "development grants."

POLICY CONCERNS

The IMF Has Strayed From Its Core Responsibilities

The IMF is a monetary authority, not a development agency. It should therefore focus on crisis lending and macroeconomic policy advice. It is best suited to play the role of international lender of last resort. But it has recently strayed into quasi-development issues such as poverty reduction. A task force report by the Council on Foreign Relations [CFR] concluded that "the IMF is losing its focus and reducing its effectiveness by doing too much." A similar report by the Overseas Development Council [ODC] agreed that the IMF should scale back its activities and focus on its core mission of macroeconomic policy.[3]

The administration's proposal would continue "mission creep" at the Fund. The IMF's gold sale will establish an endowment that will provide a permanent source of funding for its "concessional" lending facilities. These lending facilities, such as the Poverty Reduction and Growth Facility [PRGF], closely resemble development aid and many observers, such as the CFR and ODC, have advocated transferring these programs to the World Bank.

Development aid and poverty reduction are worthy goals, but the U.S. *already* funds these activities through its financial support of the World Bank and several regional development banks, such as the Inter-American Development Bank, the African Development Bank, and the European Bank for Reconstruction and Development.

More Autonomy for International Bureaucrats, Less Influence and Oversight From the U.S.

In addition to greatly expanding the NAB, the IMF also would like to make it "more flexible." In other words, the IMF would gain significantly more discretion over how these funds will be used. The Fund would gain much more discretion in deciding which situations were "exceptional" and required NAB funding. Previously, the U.S. Treasury would be a key decision maker in how NAB funds would be used, but the new "flexibility" language gives more power to the managing director of the IMF to influence such decisions.

The idea of an emergency credit line for temporarily distressed countries sounds reasonable, but the IMF's language raises the concern that this NAB "emergency" money could simply be used for "general" IMF purposes. In fact, an IMF spokesman last month told *The Wall Street Journal* the thinking behind this increase in flexibility is that "the NAB money becomes part of the general resources of the fund and if the managing director decides that the fund needs to step in somewhere, it can."[4]

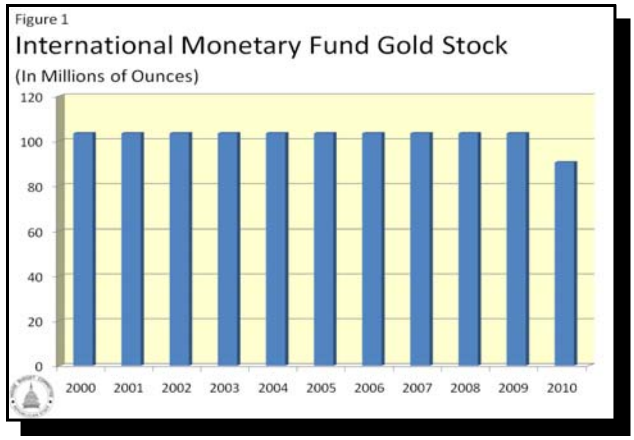
---

[3] Congressional Research Service report RL32432.

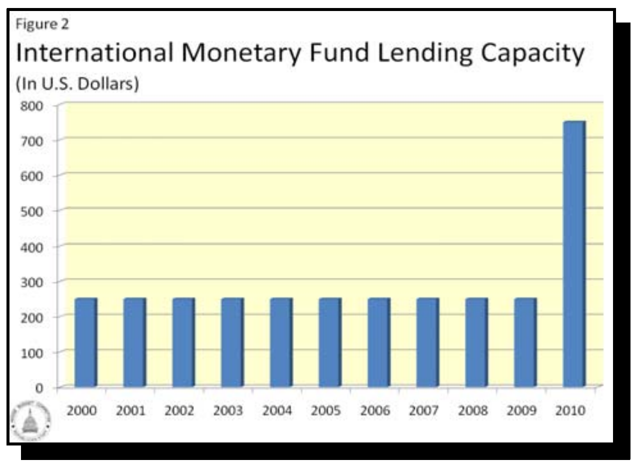
[4] http://online.wsj.com/article/SB124259862298228133.html

The U.S. already is poised to have less of a voice in future IMF decisions, as other countries – such as China and India – lobby for an increase in their voting power and a reduction of U.S. influence. In fact, one key advisor to the Treasury Secretary has advocated that the voting majority needed to approve IMF decisions should be reduced from 85 percent to 80 percent, a measure that would eliminate the current U.S. veto power over IMF decisions.[5] (The U.S. has a 17-percent voting share at the Fund, which means it holds an effective veto vote because key IMF decisions require an 85-percent majority.

The IMF's gold sale, and the establishment of a permanent endowment to support its operating expenses, would also put its core funding on "autopilot," eliminating the need to periodically come back to Congress to justify an incremental increase in funding. This would erode an important measure of congressional oversight. Increased funding combined with less oversight rarely yields good outcomes, especially with regard to an international institution that seems to lack a clear and focused mission.



The IMF plans to sell roughly 13 percent of its gold stock, which will erode a critical capital buffer from its balance sheet (see Figure 1). As the IMF states on its own website, it holds gold for prudential reasons and to meet "unforeseen contingencies." At the same time, the Fund is tripling its lending capacity, from roughly $250 billion to $750 billion (see Figure 2). A lower capital buffer, combined with much higher lending, is precisely the mix that impaired many financial institutions during the latest economic crisis.



Shifting Responsibility Over Fiscal Affairs
From Congress to the Treasury

One especially troublesome aspect of the proposed new SDR allocation is that it *does not* require the explicit approval of Congress. Under the Special Drawing Rights Act of 1968, Congress set forth guidelines for U.S. participation in the SDR Department, the division of the IMF in charge of creating and managing this international reserve currency. Significantly, that Act says that if

[5] http://www.voxeu.org/index.php?q=node/2896

the U.S. share of a new allocation of SDRs is less than the size of the U.S. quota (currently 17 percent), the U.S. can support it as long as the Treasury Department consults with leaders of the House and Senate authorizing committees at least 90 days prior to the vote. (In the present situation, this 90-day period began on 13 April 2009.)[6] In addition, since 1980 Congress has required that increased contributions to the IMF be subject to the authorization and appropriations process.

This new SDR allocation request appears to be specifically designed so the Treasury does not need explicit congressional approval to agree to this provision. This represents a significant increase in the fiscal powers of the Executive Branch. SDRs are contingent liabilities for the U.S. taxpayer because they can be exchanged on demand for U.S. dollars; but it is Treasury, not the Congress, that is signing off on their issuance. By all accounts, this new SDR allocation is an extraordinary measure. SDRs have only been issued two other times in the history of the IMF: once when the IMF was created, and again in 1981 when the total allocation was increased to $32 billion. The latest proposal would increase the SDR allocation by a staggering $250 billion, an eight-fold increase.

SDRs are allocated to each IMF member country based on their representational share at the Fund. Therefore, creating more SDRs is like giving member countries such as Iran, Venezuela, Myanmar, and Sudan the green light to access a dollar loan on demand at a below-market interest rate. Congress should fully consider whether this is a wise policy, from both an economic and a foreign policy perspective. It is hard to imagine Congress voting for a stand-alone measure to provide a subsidized dollar loan to a country such as Iran. Ironically, the Treasury's own division of foreign asset control is working to stop countries such as Iran from gaining access to funding that may be used for terrorist purposes, while its international affairs division is apparently signing off on a dollar line of credit to that same country through the IMF.

Potentially Undermining the Value of the Dollar

The IMF literally creates its SDRs out of thin air, but these SDRs can then be exchanged for real dollars at the U.S. Treasury. (Treasury either borrows money or the Fed prints the money to make the exchange.) SDR creation therefore leads to an increase in the global supply of dollars. The Federal Reserve has already greatly expanded the dollar monetary base to ease credit conditions in the economy, while the Treasury is issuing debt at record levels. Foreign investors have grown concerned about U.S. debt levels and the potential for inflation down the road; and this concern has recently led to an increase in interest rates and a decline in the value of the dollar.

It is far from clear that obligating the Fed to print more money, or the Treasury to increase its borrowing for dollar loans to other countries, is a wise policy in this economic environment. Even if the SDR allocation would only have a marginal negative impact on the value of the dollar (and the size of the allocation compared to the size of the total dollar foreign exchange markets suggests that it would), this would represent one more factor that could push inflation higher.

At a more conceptual level, the IMF's synthetic currency is part of a discussion that could undermine the role of the dollar in the world economy. For instance, the Governor of China's

[6] Congressional Research Service Report R40578.

central bank made headlines earlier this year by saying the U.S. dollar should be phased out as the world's reserve currency and replaced with the IMF's SDR.[7] (China is the largest official holder of dollar-denominated reserve assets.)

The SDR is unlikely to displace the U.S. dollar as a global reserve currency any time soon, but the increased discussion is cause for concern. The IMF also is preparing to issue its own SDR-denominated bonds. These IMF bonds could lead to a shift away from the dollar and Treasury securities by global investors concerned about U.S. fiscal and monetary policies and the retention of value of their dollar-denominated assets.

The U.S. reaps a number of important economic benefits by having the world's reserve currency. The dollar is the preferred currency of international trade (most major commodities are denominated in dollars) and financial transactions. Foreigners, particularly official holders, tend to recycle their dollars in the United States' highly-liquid domestic bond market by buying up U.S. Treasuries. That ready source of foreign demand for Treasuries helps to keep U.S. borrowing costs low. If the dollar fell out of favor in international markets, and countries replaced their foreign reserves with some other currency, U.S. borrowing costs would be significantly higher. As the value of the dollar declined, higher import prices would also lead to upward pressure on inflation.

BUDGET SCORING OF IMF PROPOSAL, AND OTHER ISSUES

U.S. contributions to the IMF are effectively a line of credit. The treatment of the IMF in the Federal budget has varied since its creation in 1944. In 1967, the President's Commission on Budget Concepts provided a comprehensive reform of the treatment of spending, taxes, deficits, and debt that continues to serve as the basis for Federal budgeting today. That commission recommended that U.S. contributions to the IMF not be recorded in the Federal budget. After the enactment of the Congressional Budget Act in 1974, there was a recognition that contributions to the IMF reflected a financial commitment, and there were concerns with congressional oversight and the budgetary treatment of U.S. contributions to the IMF.

Congress moved to require that these contributions be subject to the authorization and appropriations process. In 1980, the budgetary treatment of the IMF was also changed to score budget authority to the amount of the contribution, with zero impact on outlays (spending), the deficit, or debt.

In the President's fiscal year 2010 budget, the administration proposed there be no budget impact recorded from U.S. contributions to the IMF. The Budget Committees rejected this proposal, but recognized that the current budgetary treatment of recording budget authority with zero impact on spending and deficits was flawed. In 1990, Congress enacted the Federal Credit Reform Act [FCRA], which provides a methodology for recording the budgetary impact of Federal credit reform programs.

In developing the Troubled Assets Relief Program [TARP], the Budget Committees recognized

[7] http://online.wsj.com/article/SB123780272456212885.html

that FCRA did not fully account for market-related risks associated with Federal credit programs. For the TARP bill, Congress provided that FCRA be used in recording transactions for the TARP, with an added adjustment for market risk.

After reviewing the issue, the Budget Committees concluded that FCRA adjusted for market risk was the best measure of recording the impact of contributions to the IMF on the budget. The Congressional Budget Office has since analyzed the administration's proposal using this methodology, and has estimated that under FCRA the administration's proposal would lead to $5 billion in budget authority and $5 billion in outlays over the next 5 years.

Additional information on the budgetary treatment of the International Monetary Fund:

The Senate Budget Committee Republican Staff:
http://budget.senate.gov/republican/pressarchive/2009-05-18BudgetPerspectives.pdf

The Congressional Budget Office: http://cboblog.cbo.gov/?p=270

Prepared by . . . . Timothy P. Flynn
Chief Economist