THE G-20 HAS DISAPPOINTED ON INTERNATIONAL FINANCING

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Framing the Issue

The G-20 is in trouble. After successfully orchestrating a coordinated fiscal stimulus in 2009, the G-20 turned to longer-term issues to strengthen and sustain global growth. The instinct was right. The global economy appeared to have an imbalance between the demand for capital, largely in emerging and developing economies, and potential supply, with long-term risk capital concentrated in advanced economies. Adjusting the international financial system to encourage an intermediation of capital flows into appropriate and productive investments was clearly needed to achieve a structural global rebalancing that would deliver stronger and more stable growth.

In practice, little has happened. Capital flows to developing economies have been "hot" portfolio investments, and their volatility and impact on exchange rates may have served to reduce rather than increase infrastructure investment. Huge public resources have been marshaled for the International Monetary Fund, but mostly these seem destined to construct a firewall around Europe, and the destabilizing accumulation of massive foreign exchange reserves by developing countries has continued. Increases in the capital of multilateral development banks have been approved, but they are modest in size and needed governance reforms are slow in coming.

Developing economies today are struggling to find the resources to invest in infrastructure. Their populations are growing and urbanizing at the fastest rate in history. They must upgrade construction standards to account for future climate change. Their economic progress depends on efficient logistics to link them with the global economy.

At the same time, advanced countries are struggling under the yoke of austerity. However, the pendulum seems to be swinging toward adjustment packages that include more room for growth. Public deficit financing for aggregate demand management is important, but so is smart government spending that raises long-term productivity growth, such as on infrastructure.

All this needs money—an estimated $1 trillion annually in additional investments and maintenance for developing countries alone, over and above the current infrastructure investment rate of $0.8-0.9 trillion per year; this is according to the G-24, an intergovernmental group that coordinates developing countries on development issues. Mostly this money is needed in low and lower-middle income countries (categories that exclude China, for example), and is destined for power generation, transmission and distribution.

Policy Considerations

The G-20 should urgently consider whether the existing institutional structure is adequate for promoting the huge flows of capital that are required. At present, its focus on the international financial architecture has been largely concerned with stability issues rather than growth. For example, the G-20 has committed to implement agreed-upon governance and quota reforms before the IMF and World Bank annual meetings in October, to a comprehensive review of the quota formula by January 2013, and completion of a new round of quotas by January 2014. The G-20 successfully mobilized pledges for $430 billion in new money for the IMF to build a firewall of sufficient size around the eurozone's problems, but these pledges were conditioned on completion of the quota reform program— a step that is already behind schedule due to upcoming elections in major G-20 countries. In addition, the scale of resources may be insufficient unless vulnerable countries are prepared to do their part in accepting reforms and austerity. That is more likely if their path forward is eased by adjustments in surplus countries as well.

The G-20 has not, however, paid equivalent attention to the problem of insufficient long-term capital for public investment. Advanced countries have approached infrastructure investment with the idea that public-private partnerships will be a panacea. Yet, the experience so far has not been encouraging, except in selected areas such as telecommunications. Private investment could contribute perhaps 20 percent of the overall infrastructure financing needs of developing countries, leaving a sizable funding gap that cannot be completely filled with domestic resources in most poor countries.

The intellectual case for a big push on infrastructure is strong. It could support global growth and structural change, especially urbanization, in an environmentally responsible fashion. It could provide a stimulus to global aggregate demand. It could promote regional integration, especially in sub-Saharan Africa. It is critical for raising agricultural productivity and food security, and more broadly could be an instrument for more inclusive growth.

Official financing has failed to respond to these challenges. For the past 15 years, the scale of net official flows to developing countries (excluding IMF loans) has hovered around 0.5 percent of developing country national income. Recent capital increases of multilateral development banks do not appear sufficient to change this in a significant way.

For these reasons, there are now discussions about a new development bank to provide additional resources for public investment. Those discussions have highlighted the institutional deficiencies of the existing framework. There is a need to modernize international financial institutions in terms of their mandates, membership and governance, and modalities if the infrastructure challenges are to be met. New mandates could prioritize funding "green" infrastructure and agricultural productivity in an environmentally responsible way. Membership could be updated to tap into new capital sources such as sovereign wealth funds, as well as rebalancing the shareholdings of emerging and developing economies to reflect their true weight in the global economy. Modalities could be broadened to include a range of risk-reducing and leverage-inducing instruments, such as guarantees, mezzanine structures, fund-of-funds and partnerships.

The G-20 is unlikely to take up the issue of a new development bank—that was already discussed at the BRICS Summit in New Delhi in March 2012. But the G-20 should take seriously the issues raised, namely the need to modernize and focus the mandates, membership and governance, and modalities and instrumentalities used by multilateral development finance institutions.

To be fair, there is a willingness to experiment and take small steps forward. Several G-20 members are likely to pledge additional resources for agriculture and food security, for example. The International Finance Corporation, the Asian Development Bank and the U.K.'s Department for International Development are launching a Climate Public-Private Partnership Fund to use public sector seed capital and policy dialogue capabilities to attract large pension fund capital to invest in resource efficiency and low-carbon infrastructure assets and services in Asia. But these efforts fall short of a more complete assessment of the institutional gaps in the existing financial architecture.

Action Items for the G-20

The G-20 needs to update the international financial architecture in a more balanced way:

- It has mobilized substantial resources for stability and austerity through the International Monetary Fund, but it needs to move on sharply increasing resources for infrastructure development that can promote growth in an inclusive way. This can be as useful for advanced economies that must jump-start growth and raise productivity as for emerging and developing economies trying to sustain growth.
- The pace of modernization of the international financial institutions should be accelerated. The agreed-upon calendar for IMF reforms is at risk, threatening the credibility of the political decision-making process. Reforms in multilateral development banks are proceeding even more slowly and should be given priority.
- Some reforms, such as on the use of new instruments to increase leverage and update modalities for public-private partnerships, are policy choices that do not require legislative approvals. These can be fast-tracked to deliver immediate results.