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America needs a positive IMF agenda
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DAVID DOLLAR: Hi, I'm David Dollar host of the Brookings trade podcast Dollar and Sense. Today, I'm talking with Mark Sobel, the U.S. Chairman of OMFIF. That's the Official Monetary and Financial Institutions Forum, which is the think tank for central banks and international economic issues. We are going to preview the upcoming IMF meetings which are held in the spring—they will be over the next couple of weeks. So welcome to the show, Mark.

MARK SOBEL: Thank you for having me. It's a great pleasure to see an old friend. Let's dig in.

DOLLAR: Okay. So one issue that's going to come up at the IMF meetings is apparently there's going to be a new allocation of special drawing rights. That's the IMF basket currency. I find this interesting because I believe the Trump administration was opposed to this, so this is a clear shift on the part of the U.S. administration to support the allocation. So, can you explain what does it mean to have a new allocation of SDR, and is this actually important for the global economy?

SOBEL: That's a great question. Thank you for posing it. So the special drawing right is a reserve asset that can be created with an 85 percent majority of the IMF. As the U.S. has over 16 percent of the fund's voting power, the U.S. can block an allocation. Under the Trump administration, the U.S. didn't support proposals for an allocation, mainly not seeing it as a well targeted tool. I'll come back to that in a second. It seems that the Biden administration will likely support the allocation—one of up to $650 billion—since that amount can be supported by the U.S. without congressional approval, though consultation is required.

So when countries get allocations they can sell their SDR to a country willing to accept them in return for a hard currency which can then be used to bolster reserves or provide financing. An allocation must meet the long term global need to supplement existing reserve assets. One can debate whether that test is met, though especially last March and April with the financial turmoil in the wake of the breakout of the pandemic, the pro case was strong.

An allocation is dispersed according to country's relative weight in the global economy—that is their quota shares in the IMF. That means 70 percent of the allocation is going to end up in the coffers of advanced economies and strong emerging markets that really don't have much need for them. An allocation really doesn't do the greatest job of getting SDR into the hands of those who face pandemic needs. To address that issue, there are proposals to reallocate SDR from countries with little need for them to those who need them.

You can imagine a range of proposals addressing poverty, climate, vaccine, et cetera, but a dominant idea is to reallocate SDR to augment support for IMF member low-income countries, the LICs. That sounds wonderful in practice; it's more difficult in execution because the LICs need concessional resources, not loans.

SDRs can be used unconditionally. Typically, the IMF lends when countries make reforms. There are concerns in some quarters that some countries will use SDR to pay off excessive and unsustainable debt, including to China. This has led to calls, including from Janet Yellen, for the IMF to look into ways of enhancing the transparency of any use of SDR. These ideas might include every SDR transaction being reported.

Since some bad apples like Iran and Venezuela will get SDR you are going to hear a lot of political noise about this issue. I'm not aware of Iran ever having transacted with the Fund, and certainly not for decades. The U.S., of course, would never transact with Iran.

Will it make a difference to the world economy? Sub-Saharan Africa will get roughly 4 percent of the overall allocation. So that's $25 billion out of a $650 billion allocation. That may sound small, but for some low-income countries this is a good amount of money, perhaps 6 percent of GDP, more that could be used to finance needed spending. And let's not forget how badly hurt the LICs were by the pandemic. And they just don't have the capacity to respond with fiscal and monetary policies as we do. And we still have to see if some reallocation can be developed.

As to more cosmic questions such as whether this will impact the reserve role of the dollar or the RMB? The answer is no. This is irrelevant to that no matter how carried away some SDR dreamers get.

So in conclusion, the case for an allocation is not a slam dunk. I do think the fund and its members need to urgently work on some of these issues around reallocation and debt transparency. I support the U.S. view to back an allocation at this point. The U.S. was isolated on this issue. The allocation can help some countries, including LICs, deal with tremendous pain. Backing an allocation is a useful way for the United States to support multilateralism and the IMF.

As you know, I'm a big fan of both. America needs a positive IMF agenda. The IMF well serves U.S. interests, and we turn to it ASAP anytime there's an international financial crisis. We can't say no to everything IMF-related or delay our financial support for the IMF for years, as we did with the quota increase, and still be seen as a leader, especially at a time when China is rising. Supporting an SDR allocation is part of that equation.

DOLLAR: Mark, thank you. That was a really clear answer, and I think you captured it very nicely that it may not be the best targeted mechanism but it's something that can actually be done quickly and has the political positive spillovers you discussed at the end. So that sounds quite positive.

As you indicated in your answer, a lot of developing countries have really had devastating effects from the pandemic and the global recession. Some of the poorest countries, but also some of the emerging markets that are more middle income. So one thing that happens in IMF meetings is there's always a focus on some of the problem countries. So, who do you see as the countries at risk at the moment, and how does this tie more broadly into the international community's efforts to address that vulnerabilities?

SOBEL: Well, thank you for that. You know, we often talk about emerging markets (EM) and LICs in a broad sweep, which isn't really fair or useful because countries face different circumstances. So on the EM side especially there needs to be differentiation. The pandemic obviously hurt everybody, but in thinking about EMs—you are a tremendous China expert, you know that China has the resources to handle its own issues. Many Asian countries have surpluses and good reserve cushions. Looking at Latin America, countries such as Mexico, Chile, Colombia and Peru tend to be good, decent performers, though they have their issues. Of course, the picture is less positive for others, and the pandemic has exacerbated their problems.

Argentina, despite the debt restructuring, is facing questions about whether it can bring its primary deficit down far enough that it can be smoothly financed without inflation and exchange rate pressures. Turkey is running highly unorthodox policies that are undermining sustainability and confidence. There are those who often muddle through or face stress for homegrown reasons—endemically, Pakistan, Ukraine, for example. And despite some good efforts, Brazil hasn't been able to bear down sufficiently on its fiscal dynamics and is seemingly unable to carry out its reform agenda. On the other hand, its debt is in local currency and it has large reserves. I worry about some of the frontier economies who have questionably borrowed on international markets, for example Kenya or Zambia. So those are some of the emerging markets.

On LICs, I want to turn to another major issue for the upcoming spring meetings. Again, the pandemic has really ravaged the LICs. Many face pressing needs and debt distress—they did so before the pandemic. Many also have large bilateral official debts, often to China, now the world's largest official bilateral lender. Last year, as you recall, the international community launched a debt service suspension initiative, the DSSI. About 77 countries were eligible and about $5 billion of debt service relief has been provided. But as you know, David, many countries have unsustainable debt.

Unsustainable debt should be written down. The advanced economies eliminated their official debts to LICs over a decade ago through the Paris Club under the multilateral debt relief initiative. To address this write down issue, the G20 endorsed a common framework last year. It built on the DSSI. But as is often the case with international statements, there's a lot of room for interpretation. And as you know, I've negotiated many communiques in my life, so I know just how squishy they can be.

China isn't a member of the Paris Club. It doesn't follow Paris Club like principles. It will often roll over its exposure, but it has been reluctant to take care of cuts. The two main development lenders in China are the China Development Bank and China XM. China argues that the development bank is a private lender; few agree. Meanwhile, the private sector has been trying to stay as far away from debt relief as possible.

I think there's a big issue out there on whether enough debt relief is being afforded for LICs. I think much more progress is needed here. The common framework is loose, squishy almost. It at least provides a vehicle for other countries to keep pressing China—and other non-traditional lenders as well—to restructure unsustainable debts. The private sector needs to be pressed as well.

Progress also could be helped very substantially if there were far more transparency around debt: the amounts, the terms, the maturities. And I think the IMF and the World Bank should be playing far bigger roles here.

DOLLAR: Thank you, Mark, I appreciate your concern for the low-income countries, the lowest income countries, which as you say have really taken a devastating hit. If we can successfully support some debt restructuring, some debt write-downs through the mechanisms you just talked about, in general many of these countries will also need new resources from the IMF and from other sources. Does the IMF have enough ammunition to take care of these different financial problems around the world?

SOBEL: Thank you for that. So for the bulk of its members, such as emerging markets or advanced economies such as Greece a decade ago, the IMF finances itself through its quota resources in the first instance. So it has about $225 billion of remaining loanable quota resources. And behind the quotas are emergency lending lines, the first one being a multilateral line called the new arrangements to borrow. And if it runs low of that it can tap some bilateral loans it has.

The new arrangements to borrow on the bilateral loans total about $800 billion. So the fund has a trillion dollars of resources that it could lend and I think that's adequate to meet systemic problems and current demands. Now, whether the funding is allocated properly among those pots is another question for another day.

There are those critics out there who say the fund is being timid and it's not mobilizing its balance sheet sufficiently these days, and it should do so far more extensively. That's a point of view. It would require major change in foreign policy procedures, access limits, and most importantly I'd say the way national governments that put up the funds financing see the situation. So while the fund supported strong, unconditional liquidity support last year in the immediate aftermath of the crisis, the member governments want the fund to be a bit cautious. They don't want to tell their Parliament's that the IMF lost money on their contributions and the like. So I think you're unlikely to see them take a fundamentally different approach.

Now, the way the fund finances low-income countries is different. That comes mainly through something called the poverty reduction and growth trust, the PRGT, which is funded through national contributions—voluntary contributions, I should say.

So countries make loans to the PRGT, but the PRGT lends at zero for the low-income countries. So to bridge the gap between the lending rate and the zero concessional rate, countries also give subsidy resources to the PRGT. Plus the IMF has some further subsidy resources. The

PRGT runs in principle as an endowment able on a self-sustained basis to commit about one and three-quarter billion dollars a year. However, it committed almost $7 billion last year, given the pandemic. The IMF has been trying to substantially boost resources for the PRGT in light of the pandemic. I think there's a reasonable and decent case for more PRGT funding, though the case needs to be defined and spelled out.

One more point on this. The U.S. only gave modest amounts of PRGT funding ages ago. The LICs as we've discussed have been seriously hit by the pandemic. I find it extremely disappointing that America hasn't given a contribution of subsidy resources to the PRGT at this time. Surely in a $900 billion or a $1.9 trillion fiscal package, America could have afforded a few hundred million dollars for the poorest nations. It would have been scantly noticed in the bills, yet it would have been a great sign of multilateralism and showing we cared. It would constitute a part of a positive U.S. leadership agenda in the IMF. So this is a huge missed opportunity, in my view.

DOLLAR: So what I hear you saying, Mark, is there's some imbalance among the different resources we have. The IMF in general has sufficient resources, but not enough concessional ones to really help the poorest countries. Then plus, as you pointed out earlier, the countries that really have unsustainable debt need debt relief, not just new money. Is that fair?

SOBEL: That's a reasonable summary of my views. Yes.

DOLLAR: So Mark, you mentioned the recent $1.9 trillion U.S. recovery legislation. So this is a very significant piece of recovery, which will essentially stimulate the U.S. economy. One thing that happens at the spring meetings, the IMF will come out with an updated forecasts, probably they'll have a more optimistic forecast for U.S. growth and for the global economy.

This whole package should be good both for the U.S. and for the world. In particular, it's going to stimulate other country's exports, but it's also likely the lead to higher U.S. interest rates. Sometimes when there's a rapid shift in interest rates we get big movements of international capital—what we often refer to as the reversal of flows. If money has been going to the developing world but the U.S. raises interest rates or interest rates in our markets are driven up by the policy mix, then you might get a sharp reversal and that could create new problems. So how do you see that playing out? I guess, around the corridors, are other countries mostly going to be happy with this giant U.S. stimulus or are they going to be worried about this interest rate capital flow issue?

SOBEL: I think they're going to be happy with the stimulus. There's definitely going to be some concerns over reversal of capital. As you said though, the higher U.S. growth that the interest rates reflect will benefit them and the rest of the world.

I don't think we should be fretting about this issue through the lens of the 2013 taper tantrum, in large part because emerging markets as a whole are in better shape. Many have stepped up local currency borrowing. Their external positions are often in better shape. Market positioning is more restrained now. And yes, U.S. long rates have gone up, but even so we are not seeing the contagion we saw in 2013. Again, we are not wringing our hands about the fragile five right now as we did in 2013. Sure, they have some issues, but I don't see the same amount of external vulnerability.

Now, if I thought U.S. nominal real rates were going to soar, or that the Fed were quickly shifting its gears toward restraint, I might have a different answer. But the Fed, even if it begins tapering later this year or early next, is still extremely accommodative, as are U.S. financial conditions. And Jay Powell clearly does not want to take away the punchbowl.

A footnote: you know, a lot of academic literature talks about a global financial cycle, which is often code for Fed monetary policy causing global spillovers such as swings in capital inflows and outflows from EMs and thus giving grounds for use of capital flow measures, foreign exchange intervention, et cetera. Now, clearly Fed monetary policy does affect global capital flows. Absolutely no doubt about that. But there are different kinds of capital flows. There's portfolio flows, there's FDI flows, and sometimes good or bad country performance causes inflows and outflows. So the extent to which there's a global financial cycle is an area where I think more research is warranted by the international community.

DOLLAR: Let's stick with the recovery package for a moment. You wrote a recent blog pointing out that this probably will lead to a significant widening of the U.S. current account deficit. That's the broadest measure of our trade balance. This could bring renewed concerns about global imbalances, about the size of the U.S. external deficit, and possibly currency disputes could arise.

The U.S. government has started treating currency undervaluation as a kind of subsidy that can justify the U.S. imposing countervailing duties. That is, countervailing tariffs or taxes as we did recently with Vietnamese tires and with Chinese tie twists. So I'd like to get your views on these currency issues and this issue of the widening global imbalances partly as a result of this U.S. package.

SOBEL: Well, this is one of my favorite topics to talk about. So, thank you for that. As you know, Americans have large untapped savings from the fiscal support. Some estimate over one and a half trillion dollars. We had a $900 billion package at the end of December. We just had the Biden package. Our country is moving quickly on vaccine rollout, which could mean a fast return to confidence and spending. And the forecast for the U.S. growth this year are often between 6 and 8 percent, which implies some booming quarters that we are going to see pretty soon.

Meanwhile, Europe is lagging behind on vaccine rollout and stimulus. David, as I was saying, you are one of the foremost China scholars anywhere in the world. But the fact that the authorities projected growth of at least 6 percent when most forecasts are 8 percent or higher was a sign to me that they are going to do what they can to restrain leverage and pursue a cautious macro course this year.

So there's the potential for a major global financial divergence. That could push up our current account deficit toward 4 percent versus the 2 percent plus deficits that we've experienced over the past decade.

So I've dealt with currency issues for huge swathes of my career. Some countries have pursued export-led growth models, relied on U.S. demand, and intervened to keep their currencies undervalued. At the same time, the U.S. hasn't been an innocent bystander. Some of our policies have contributed to bigger external deficits and upward dollar pressure.

Our economy has faced large adjustments. These challenges have often been caused by technological change and globalization—and or less-than-stellar U.S. policies. Still, we're prone to blame foreigners for harmful currency practices, and as I said some of that is justified. So if the Biden stimulus drives growth and higher interest rates, one could well see large capital inflows into the U.S. greater than the increase in the current account deficit, and that could mean a higher dollar. So it's not far-fetched in these circumstances to believe there could be a resurrection of disputes around global imbalances and currencies.

There's been a lot of concern among many, especially during the Obama and Bush administrations, that Treasury didn't actively deploy the manipulation tag under the FX Report. Frankly, even if Treasury had done so the label itself didn't carry much clout. And in part for that reason, the Trump administration gave Commerce the power to apply CBDs for currency undervaluation and USTR to investigate undervaluation through Section 301 of the Trade Act.

You mentioned Vietnam and tires and China and tie twist. You're right. I have been very critical of this approach. Currency undervaluation cannot be precisely measured. Models generate a wide range of results for trade weighted evaluations. Measuring bilateral undervaluation between a currency and the dollar, which is essential for the Commerce USTR exercises, is fanciful. It's also probably the case that a plus or minus 5 percent over- or under-valuation is within a margin of error.

Currency values respond to trade flows and capital flows. Capital flows often swamp trade. They, in turn, respond to monetary and fiscal policies. We just discussed how Fed actions can cause money to leave emerging markets, depressing their currencies. U.S. protectionist action and threats have tended to depress foreign currencies. Fiscal stimulus may well push up the dollar. So in these cases, the extent of perceived undervaluation can rise through no fault of the concerned country. And World Trade Organization rules do not allow subsidies specific to industry and not generally provided to all products. So currency undervaluation doesn't really meet WTO subsidy issues.

So I agree that others at times engage in harmful currency practices, and that the Treasury should roll up its sleeves and really tackle such problems. But I think the 301 CVD approach has logical flaws, and I worry that it may trigger protectionism, currency wars, and ultimately exacerbate the very conditions it seeks to address.

DOLLAR: My last question, Mark, really just follows from that discussion we were having. You have a recent blog post where you argue that Treasury should stay in control of currency policy, and what you were just describing is bringing in the U.S. Trade Representative and the Department of Commerce and using measures of currency undervaluation to lead to countervailing tariffs, for example. So could you just walk us through your thinking about why Treasury should stay? And I guess let's broaden a little bit to what do you think the U.S. currency policy should be?

SOBEL: First of all, the Treasury has the lead on foreign exchange policy. As I just said, currency movements go far beyond trade flows. In fact, capital flows, as I mentioned, can swap trade flows. Capital flows are motivated heavily by interest differentials and changes in them by fiscal policies, by basic perceptions of institutional strength, et cetera.

So Commerce and USTR have a mandate on trade issues. They have no mandate on exchange rate issues. They have no mandate on global fiscal and monetary policies. They have no mandate on capital flow issues. So even if they hire the best currency experts, they still lack an institutional mandate. You can't have an exchange rate policy for the trade accounts and another one for the capital account. You need one currency policy for the entire balance of payments.

I just outlined why I view the CVD 301 effort as highly flawed. FX Policy should remain with Treasury; the Treasury should call the shots.

Okay, and you just ask more generally what I think Treasury's policy should be. I've already said that I think that Treasury needs to forcefully address harmful currency practices. More generally, as Janet Yellen came into the Treasury, there was renewed debate—should she say strong dollar or not? My view was that in my years dealing with the media and markets, the strong dollar had become a kind of a cat and mouse game that was by the by. You know, if the dollar went up, people would say "do you support the strong dollar" to see if you had a pain threshold? If it went down, they were basically implying, well, what are you going to do about it. It just became this game. I don't think that was useful. So I give Janet Yellen absolute credit for saying that the dollar is going to be market determined because that's the way it really is and that's the policy we've pursued.

So, I think we should float the dollar, have a floating dollar. We should focus on our fundamentals. I think we should push others to be more market-oriented and flexible in their approaches to their currency manage. I think we should absolutely adhere to the G7 and G20 foreign exchange commitments that we have made over the years.

DOLLAR: I'm David Dollar, and I've been talking to Mark Sobel. I should have mentioned at the start that Mark worked for many years in the Treasury Department where he dealt with the IMF and currency issues. I may be David Dollar, but we often referred to him as Mr. Dollar because of his role in overseeing the U.S. dollar, our policies toward currency. Thank you very much, Mark, for helping us understand the issues that are coming up at the IMF Spring Meetings and the international financial issues that they address. So, thank you very much.

SOBEL: Thank you for having me.

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