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The United States and the Large Emerging-Market Economies: Competitors or Partners?

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The world has seen over the past 30 years a substantial expansion in the number of sovereign actors whose decisions can have important positive and negative implications for the global economy. Essentially all of the new actors are large emerging-market economies (LEMs)—the top tier of developing economies. Over the same period, the relative economic importance of the industrial economies, large and small, has waned.

The LEMs are important to the United States because collectively they are now a major source of growth for the world economy and of stimulus and economic and financial opportunity for the US economy, businesses, and investors. The 11 LEMs that we focus upon in this chapter represent over 31 percent of world GDP (on a PPP basis) and grew at about a percentage point faster than the world or G-8 economies in the 1992–2002 period.[1] Two of these countries (China and India) rank first and second (respectively) in terms of their trade growth over this period. Finally, the 11 countries currently control over 30 percent of total international reserves.

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1. The eleven countries are Argentina, Brazil, China, India, Indonesia, Korea, Mexico, Russia, Saudi Arabia, South Africa, and Turkey. They account for about 14 percent of world income and production at current exchange rates (World Bank atlas method).

As has been seen over the past 10 years, starting with the Mexican external financial crisis of 1994–95, the LEMs individually also can be the source of disturbances that disrupt the international financial system, with adverse effects on the United States. In addition, choices by countries such as China to limit the adjustment of their currencies can impair the working of mechanisms for adjusting international payments imbalances and negatively impact many sectors of the US economy.

Increasingly, many observers see the LEMs as serious competitors to the United States. However, our view is that the interests of the United States and the LEMs can be aligned sufficiently so that they can and should be partners.[2] As consequential players on the world economic stage, and in their own interests, the LEMs will want to share responsibility for global prosperity.

In this chapter, we address why being partners with the United States, as well as with the European Union and Japan, is in the best interest of the LEMs as well as the United States and other major industrial countries and what the specific areas of most immediate and profitable partnership are. The potential impacts of the LEMs' decisions on the global system as well as on the United States are substantial at the same time that their aspirations are sizable. Their aspirations include a desire for sustained growth along with global economic and financial stability. The LEMs also desire increased recognition of their importance and to share responsibility for global decisions, in particular decisions that affect their needs and priorities.

We also argue that the LEMs should receive higher priority in US international economic policy. In the past three decades, US policy toward emerging-market economies, to the extent that there was one, has oscillated between preaching the virtues of market-determined foundations for growth and designing cooperative interventions to address particular problems on a case-by-case basis, such as a debt crisis in Brazil, legal uncertainty in Russia, or openness to investment in India. On the political/diplomatic front, the United States has for the most part dealt with the individual LEMs in isolation, with one issue dominating the agenda (for instance, nuclear proliferation with India, trade openness with Brazil, and human rights with China). This "one-note" approach has not contributed to building stronger, more diversified relationships with the LEMs—individually or as a group. In plain terms, there has not been a comprehensive US policy or one that takes into account the challenges the United States has in common with these countries or that the LEMs consider important in dealing with and integrating into the world economic system.

In the cases of Brazil, China, and India, for example, severe energy deficiency is a common economic problem whereas technology sharing with

2. In his chapter in this book, Nicholas Lardy argues that China should be seen as a US partner rather than as a competitor, and we make the same argument for the broader set of LEMs.

the rest of the world and scientific development within each country are common aspirations. Regional economic leadership and integration are challenges for South Africa, India, Brazil, and Russia. On the strategic economic front, protection of the Sea Lanes of Communication (SLOC) is as vital to India and South Africa as it is to Japan and the United States. The solution to military conflicts within and along their borders is of crucial importance to India, Russia, and, potentially in the future, Brazil. It is worth remembering that many of the LEMs border several of the so-called failed states, which implies future risks and the need for resources and knowledge to deal with the security and human dimensions of problems that ultimately have economic consequences.

The above examples illustrate how the United States is not weighing appropriately the aspirations of LEMs in formulating its policies. Let us be clear: We expect US policymakers to pursue vigorously the economic interests of the United States. But we also believe that this can be best accomplished by gradually bringing the LEMs individually and collectively into US counsel on the major matters affecting the world economy and their strategic objectives. It is only by doing so that the United States can reduce the influence of reactionary (i.e., "anti–global integration") forces within these countries—for instance, parts of the foreign policy establishments in Brazil and India or parts of the military hierarchies in China and Russia.

Summary of Recommendations

We have two sets of recommendations on US policy toward the LEMs. The first set of three recommendations requires initiatives and changes by the G-7 countries and, therefore, strong US leadership to bring them about. The second set of five recommendations requires the agreement and active involvement of the LEMs if it is to be implemented. We believe these two sets of recommendations taken together are uniquely relevant to the largest of the emerging-market economies and as such offer a crucial opportunity to engage these countries and improve the governance of the world economy.

Our central recommendation is that US policy toward the LEMs should be reorganized and refocused. The LEMs should receive a substantially greater share of the intellectual and other resources of the US government. As we describe, the LEMs have certain characteristics related to their economic prowess as well as aspirations for participation in the global economic system that justify this differentiation of treatment from other industrialized and developing countries. Under our proposed approach, the United States would have a more coherent and effective posture toward these countries, whose problems, interests, and aspirations are often very similar.

Governance and Institutions

Our three principal recommendations regarding the governance and institutions of economic policy with respect to the LEMS are:

1. replace the finance G-7 with a refocused G-20
2. redistribute chairs and shares in the international financial institutions (IFIs)
3. reorganize US policymaking toward the LEMs

Active Collaboration

Our five proposals for areas of active collaboration between the United States and the LEMs are grouped under two headings: (1) poverty-reducing economic growth and (2) crisis resolution and global financial stability. Our objective in making these recommendations is both to suggest action areas that are in the US interest and to identify relevant issues that would respond to LEMs' aspirations.

Poverty-Reducing Economic Growth

4. undertake initiatives in private-sector development
5. increase cooperation on development issues
6. increase cooperation on tax evasion

Crisis Resolution and Global Financial Stability

7. create a proactive framework for crisis resolution
8. resume regular annual special drawing rights (SDR) allocations

In the following sections, as a preamble to our specific proposals, we address the following questions: Who are the LEMs? Why should the United States be interested in these countries? Why should LEMs care about taking a more responsible role in the existing governance structure of the world economy? We explore the aspirations and objectives of LEMs and what, in particular, distinguishes the largest countries from the smaller emerging-market economies. We then briefly describe our three recommendations on how US foreign economic policymakers should deal with the growing importance of LEMs in global economics and politics, followed by our five recommendations for active collaboration between the United States and the LEMs. A budgetary reality check on our recommendations concludes that they are fiscally responsible.

Who Are the LEMs?

The LEMs are a subset of the continuum of economies that extends from the wealthiest industrial country to the poorest developing country. The LEMs have not yet attained the level of per capita income nor have they generally established the public and private institutions that are characteristic of an industrial country such as Canada, Australia, or most members of the European Union. At the same time, they are no longer poor or very poor because they have either experienced or are experiencing a period of rapid economic expansion. Economic, financial, and political institutions have been developed in parallel with their economic maturation, although they are generally not as robust as institutions found in industrial countries.

We are primarily interested in the *large* emerging-market economies—for example, India rather than Singapore. The LEMs' size means that their policies and subsequent development successes or failures have potential measurable impacts on the US and other global economies. They also can mobilize real and financial resources on a sufficient scale to contribute significantly to the achievement of global objectives.

Of the 11 LEMs we focus on, 5 stand out prominently as an inner circle of countries with which US economic policymakers need to upgrade and intensify their level of interaction: Brazil, China, India, Russia, and South Africa. One might argue that China deserves to be in a category of its own, that South Africa is too small in economic terms to be in the same company of the other countries, that Russia is being included for historic and military reasons, or that Mexico ought to be included in the inner circle.

On these points, our view, first, is that China, despite its progress and dynamism, is still an underdeveloped economy with only a rudimentary financial system compared with the rest of the world and therefore not yet in a position to be a full participant of the world economy (see Nicholas Lardy's chapter in this book). Second, Africa as a continent cannot be excluded from global economic decision making, and South Africa seems to us a better representative politically and economically of that necessity than any other African country or grouping. In addition, South Africa ranks slightly ahead of India and Russia but just behind China in terms of the financial stake in the country by US investors and lenders—foreign direct investment (FDI), bank claims, and portfolio investments (table 5.1). Third, although Russia was included in the G-8 primarily for political motivations, it currently ranks above India, Brazil, and Australia in terms of its share of world trade. Fourth, Mexico is politically important to the United States, though its posture vis-à-vis the Iraq war also clearly demonstrated its independence. However, as an economic actor on the world stage, Mexico is not that different from the state of California in terms of its linkages to, and dependence upon, the US economy.

Table 5.1 Economic and financial importance of the five principal large emerging-market economies (LEMs) (annual percent change 1992–2002, except as noted)

				United States	
Country	**Real GDP growth**	**Real trade growth**[a]	**Growth in reserves**[b]	**Growth in trade**[c]	**Investment**[d] (billions of dollars)
Brazil	2.6	7.4	5.3	7.7	91.8
China	9.8	15.4	30.3	16.1	28.0
India	5.8	12.3	27.9	10.7	27.6
Russia	–2.0	5.3	22.4[f]	13.8	26.2
South Africa	2.2	5.2	19.5	4.7	24.4
Average (5)[e]	5.1	9.1	20.8	10.6	197.9
World	2.5	6.4	11.0	6.6	5,572.8

a. Merchandise exports plus imports.
b. Excluding gold.
c. Exports plus imports in nominal terms.
d. Foreign direct investment plus bank claims plus portfolio investment.
e. Total US dollar amount of US investment.
f. Base year 1993; 1992 data unavailable in source.

Sources: Real GDP growth and real growth in merchandise trade: World Bank's *World Development Indicators 2004.* Growth in reserves: IMF's *International Financial Statistics* (June 2004). US trade growth: *Direction of Trade Statistics* (June 2004). US investment: FDI—Bureau of Economic Analysis (2003); bank claims—Federal Financial Institutions Examination Council (2003). Portfolio investment (equity securities and long-term and short-term debt securities): *IMF Coordinated Portfolio Investment Survey* 2003, based on US Treasury international capital system surveys.

Table 5.1 presents data on the five principal LEMs. These five countries have been and will continue to be a major source of stimulus and economic and financial opportunity not only for the US economy but also for the global economy. On average over the 1992–2002 decade, their economies grew more than a percentage point faster per year than the world as a whole, their real trade grew almost three percentage points faster, and their international reserves grew almost 10 percentage points faster. Despite differences in their respective performances, as a group these countries have been a source of dynamism for the world economy.

From the standpoint of the United States (the last two columns in table 5.1), merchandise trade with these five countries grew, in nominal terms, four percentage points faster per year from 1992 to 2002 than US trade with the world as a whole. Moreover, by 2003 the stock of US investment in these countries (FDI, bank claims, and portfolio investment, including investments in both equity securities and long-term and short-term debt securities) was 3.6 percent of total US investment in the world.[3]

3. In his chapter in this book, Lardy cites, from Chinese sources, a figure for US FDI that is about twice as large as the one embedded in table 5.1. We are forced to use US data to be consistent. Available data do not provide adequate time series for US overall or direct investment in individual countries. However, from 1992 to 2002, FDI from all countries in these

The six other LEMs, which make up the outer circle, share most of the potential and interests of the inner circle of five, but the additional countries are smaller and likely to remain so. This second concentric circle of economically significant LEMs includes countries that may take leadership roles on a certain issue—for example, Saudi Arabia on energy issues. It is convenient to identify this larger group of LEMs with the 11 large emerging-market economies that are members of the Group of Twenty (G-20) finance ministers and central bank governors—the finance G-20: Argentina, Brazil, China, India, Indonesia, Korea, Mexico, Russia, Saudi Arabia, South Africa, and Turkey.[4] Membership in the G-20, which was established in 1999, was based in part on considerations of political balance. One can certainly quibble with where the lines were drawn, but our judgment is that the balance is about right.[5]

Table 5.2 presents data on the six other LEMs. The growth rates of their economies, trade, and international reserves were also higher, on average, than for the world as whole. Of course each of these countries, with the exception of Saudi Arabia, experienced a major financial crisis during 1992–2002, which influenced the data presented in the table. Nevertheless, their share of global international reserves (excluding gold) increased from 6.5 percent in 1990 to 10.3 percent in 2003. During the same period, the share of total reserves held by all 11 LEMs rose from 11.2 to 30.8 percent, led by the increase in China's share from 3.5 to 13.1 percent.

US trade with the six additional LEMs did not expand particularly rapidly from 1992 to 2002, in part because of their economic and financial difficulties. However, US investors have a larger stake in these countries, on average, than in the five principal LEMs.[6] The US investment stake in the 11 LEMs is 8.3 percent of its stake in the world. The 11 countries as a group accounted for 30.2 percent of total US merchandise trade (exports plus imports) in 2003. The share of the five principal LEMs, led by China

five countries increased by 724 percent compared with an increase in total world FDI of 229 percent. The increase in FDI in the EU-15 was 220 percent and in the United States was 219 percent. Of the five principal LEMs, the smallest increase in FDI was for South Africa at 347 percent.

4. The other members of the G-20 are the G-7 countries, Australia, and the country holding the EU presidency, when not a G-7 country. The G-7 countries are Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

5. In terms of 2002 GDP on a PPP basis, the G-20 includes most of the largest countries. Iran and Thailand rank ahead of Argentina. Argentina is followed by the Philippines and Colombia. These latter two countries rank ahead of Saudi Arabia—the smallest of the emerging-market economies, on this criterion, that is a member of the G-20.

6. FDI in these six countries from all countries increased 175 percent from 1992 to 2002, slightly below the figure for the world as whole (229 percent). However, Korea (535 percent), Argentina (372 percent), and Mexico (332 percent) were significantly above that figure, while Turkey (44 percent), Indonesia (32 percent), and Saudi Arabia (14 percent) were below it.

Table 5.2 **Economic and financial importance of six other LEMs**
(annual percent change 1992–2002 except as noted)

Country	Real GDP growth	Real trade growth[a]	Growth in reserves[b]	United States: Growth in trade[c]	United States: Investment[d] (billions of dollars)
Argentina	1.7	3.2	0.5	0.9	18.0
Indonesia	3.9	2.7	11.5	5.7	16.1
Korea	5.7	12.5	21.6	6.4	75.4
Mexico	2.9	10.8	10.3	11.8	137.3
Saudi Arabia	1.9	3.2[e]	13.3	0.1	5.9
Turkey	3.3	9.5	16.0	5.8	9.7
Average (6)[f]	3.2	7.7	12.2	5.1	262.4
Average 5 principal LEMs[f]	3.7	9.1	20.8	10.6	197.4
Average 11 LEMs[f]	3.4	8.4	15.6	7.6	460.4
Industrial-country average[f, g]	2.2	5.3[h]	8.6	5.0	2,886.6
World	2.5	6.4	11.0	6.6	5,572.8

a. Merchandise exports plus imports.
b. Excluding gold.
c. Exports plus imports in nominal terms.
d. Foreign direct investment plus bank claims plus portfolio investment. Portfolio investment data for Saudi Arabia are not available.
e. 1992–2002 data on nominal trade from IMF's *Direction of Trade Statistics*.
f. Total US dollar amount of US investment.
g. G-7 plus Australia less United States.
h. 2002 *World Development Indicators* trade data unavailable for Canada, deflated 1992–2002 data from IMF's *International Financial Statistics* used.

Sources: Real GDP growth and real growth in merchandise trade: World Bank's *World Development Indicators 2004.* Growth in reserves: IMF's *International Financial Statistics* (June 2004). US trade growth: *Direction of Trade Statistics* (June 2004). US investment: FDI—Bureau of Economic Analysis (2003); bank claims—Federal Financial Institutions Examination Council (2003). Portfolio investment (equity securities and long-term and short-term debt securities): *IMF Coordinated Portfolio Investment Survey* 2003, based on US Treasury international capital system surveys.

at 9.4 percent, was 13 percent, and the share of the other six LEMs was 17.2 percent, led by Mexico with 11.7 percent.

The economic circumstances of the individual LEMs, of course, are not identical. Latin American economies tend to have lower growth rates, in part attributable to chronic low saving rates and associated fiscal pressures, large internal and external debts, and current account deficits, which have contributed to multiple external financial crises over the past couple of decades. The East Asian economies tend to have high saving rates and, more recently, chronic current account surpluses and rapid rates of accumulation of international reserves. Nevertheless, they have not avoided external financial pressures and crises.

Why Are the LEMs Important to the United States and the World?

The LEMs have common aspirations for rapid and sustained economic growth and development, for recognition of their interests in shaping the policies and institutions that guide and regulate the global economy, and for inclusion in global decision-making processes. It is in the US interest to evaluate and incorporate, if appropriate, these aspirations—and not solely to minimize the inevitable political and economic competition and confrontation. The challenge for the United States is to build relationships with the LEMs in the absence of substantial economic leverage.

The absence of such leverage over most of the 11 LEMs could reflect the relative decline in the US direct economic and financial stake in these countries over the past decade.[7] Although the dollar value of the US direct investment in them rose by almost 150 percent between 1994 and 2002, the US share of total FDI in these countries declined from 19 to 12 percent. US bank claims on these countries rose slightly, about 5 percent, between 1993 and 2003, but the US share of total international bank claims on them declined from 19 to 14 percent. US bank claims declined in absolute terms by 26 percent from 1997 to 2003. Over the same period, US portfolio investment (equity and longer-term debt securities only) rose by 14 percent, substantially less than the 70 percent increase for the world. Partly as a result, the historical absence of a focus on the LEMs as a group on the part of US policymakers and the financial community may be explained by the small share of US FDI, bank claims, and holdings of securities in the total portfolio of US foreign investments that are accounted for by the LEMs—only 8.3 percent in 2003. It is also relevant that in 2003, trade with the United States represented only 21.2 percent of the external trade of these 11 countries on average.[8]

Brazil, China, India, and South Africa are leaders of the so-called G-20 caucus of countries actively involved in the Doha Round of World Trade Organization (WTO) trade negotiations. These four countries have begun to establish leadership roles within their respective geographic regions that are commensurate with their size as well as their consequent broader interests in the smooth functioning of the global economy and financial system. As with most countries, external economic and financial conditions affect them, but a major difference is that their own policy decisions and performances also affect other countries.

Russia is not yet a WTO member, though its negotiations are well advanced, and it is an active participant in the global trading system. This

7. The data we present in this paragraph come from a number of different sources and may not be strictly comparable, but we believe that they support this broad conclusion.

8. Trade with the United States was only 13.9 percent of total trade of the inner circle of five countries.

observation underlines a further point: these five countries are large and important but not identical in their political and institutional development. China is not a democracy; doubts exist about the commitment of Russia's current leadership to democratic principles. What is interesting is the extent to which these very important political factors have not to date hindered for the most part their economic growth performance.

The LEMs, in particular those in the inner circle, have important differences that deserve the special attention of US policymakers, but they also have a number of common interests, as illustrated by the several areas in which we propose that the United States, the European Union, and Japan work together with the LEMs. Moreover, if these countries can maintain a generally stable macroeconomic environment and establish increasingly transparent regulations and robust institutions, they can expect rapid growth on a sustained basis for an extended period. This should translate into dynamic markets for US exports and profitable opportunities for US investors. The LEMs also are a source of competition for individual US firms and at the sector level. Many do not welcome competition, but it is the principal source of technical innovation and growth of US productivity (see the chapters in this book by David Richardson and Catherine Mann). At the same time, the LEMs look to the mature industrial countries, in general, and the United States, in particular, for open markets, capital, and technology.

Regardless of their policies or the international environment, the economic success of the LEMs will not be uniform or free from at least occasional financial crises. How well the emerging-market economies prepare their defenses against such crises and how well the inevitable crises are managed will strongly influence the US and global economies as well as the individual countries. Recall the reaction of global financial markets to the Russian default in 1998 in the wake of the Asian financial crisis and in the context of a slowly developing financial crisis in Brazil. The Federal Reserve lowered interest rates defensively, and the US economy rode out the global disturbance. However, deeper and more sudden crises like Mexico's in 1994–95 potentially can have quite severe implications for US economic activity and jobs. The bigger the emerging-market economy and the deeper its links with the US and global economies, the more disruptive any crisis will be.

As has been seen over the past several years with respect to China especially and a number of other emerging-market economies in Asia as well, their economic size and influence relative to the US and global economies have increased. They have the potential to contribute to global economic imbalances should they fail to adjust their monetary, fiscal, and exchange rate policies to sustain their economic and financial stability as well as their own growth rates. Increasingly, the United States must persuade these countries to exercise global economic and financial leadership

by adjusting their policies in their own interests and the global interest. As noted, the United States lacks substantial economic leverage with these countries. Leverage available in the future is likely not to be derived primarily from military or even economic strength but from a track record of two-way cooperation—in other words, helping the LEMs meet their economic, financial, and political objectives. Thus, the principal challenge in dealing with these countries, which are so important to the United States' own prosperity, is to recognize and incorporate their important economic—but also strategic—aspirations to the extent that they are compatible with US objectives. This will not be easy, as the realities of an interdependent and interlinked US economy will require the United States to do so as a partner rather than as a coopting economic hegemon.

What is an alternative scenario? The absence of substantive cooperation with the LEMs will, at best, lead to impasses and an increasing number of inefficient confrontations as happened, for example, in the wake of the WTO ministerial in Cancún. Each LEM is an economic competitor for the United States, and the United States must insist that the competition be fair, and that these countries play by the existing or, if necessary, mutually agreed upon revised global rules of the game. However, a formal grouping among the LEMs to the exclusion of the United States could become formidable competition for the G-7. On many economic as well as other key global issues (energy, technology and science, and security affairs), the LEMs could very well work among themselves to achieve similar, albeit not equal or as speedy, outcomes.

The worst possible strategic scenario would be the emergence of two economic blocs confronting and competing with each other: the G-7 countries and a substantial coalition among the LEMs. This would be reminiscent of the Cold War; only this time the stakes would be principally economic rather than ideological. From a realpolitik point of view, this path along with whatever outcomes it produces might even be in the long-term strategic interests of China, India, Russia, and/or Brazil. In that light, what now appear to be skirmishes in the international economic arena, in fact may be the "prewar" maneuvers of accumulating resources, getting organized, and testing strengths for an upcoming world economic clash. For instance, can the tenfold increase in the international reserves of the 11 LEMs since 1990 be explained by macroeconomic policy considerations alone? Do those 11 countries wield special influence over the global economy by virtue of the fact that they held 30 percent of total international reserves at the end of 2003—more than the combined holdings of the G-7 industrial countries, of which Japan's share was 70 percent? A scenario of a world economic clash, however remote, is the most compelling rationale for why the United States should care about the LEMs and for why the United States should undertake the substantive initiatives we suggest.

How Should the United States Deal with the LEMs?

We have established why the LEMs are important to the United States and vice versa. We now address how to reorganize some of the institutions of the international financial governance system and US policymaking to recognize the importance of the LEMs to the United States.

The US government should support institutional changes globally and in its internal organization so as to better position itself to interact with the LEMs. Globally, it should support the replacement of the finance G-7 with the G-20 as the principal international body to promote cooperation on international economic policy issues. The United States should also make common cause with the LEMs to redistribute chairs and shares in the IFIs. Internally, the United States should recognize the common interests and aspirations of the LEMs and reorganize its internal policymaking on an intra-agency and an interagency basis to reflect this reality.

Recommendation 1: Replace the Finance G-7 with the G-20

Meetings of G-7 finance ministers started in 1973 as meetings of the G-5.[9] Central bank governors soon joined most of the meetings. The countries also began meeting at the level of heads of state or government in 1975. At the initiative of the United States, the G-20 was established at the level of finance ministers and central bank governors by the G-7 industrial countries in 1999 in the wake of the Asian financial crisis "to broaden the dialogue on key economic and financial policy issues among systemically significant economies and promote cooperation to achieve stable and sustainable world economic growth that benefits all" (G-7 1999). Over the past five years, the G-20 has been a discussion forum; we recommend that it become an action committee and that the finance G-7 be gradually disbanded.[10]

In contrast with the mid-1970s, when the performance of the G-7 countries almost exclusively controlled the destiny of the global economic and financial system, today the finance G-7 finds itself addressing issues over which it has little control (for example, Asian exchange rate policies) and has left unaddressed issues closer to home (for example, US fiscal policy and the US external deficit). The G-7 grouping for many reasons, including the complex representation of the European Union, is less relevant and less effective than in the 1970s and 1980s (Bergsten and Henning 1996). Reducing the prominence of the G-7 in economic and financial affairs and raising the prominence of the G-20 would recognize the reality of the changing shape of the world and the increasing interdependence among a larger number of important countries. This step also would respond to the aspi-

9. The G-5 is the G-7 minus Canada and Italy.

10. Earlier versions of this proposal were made in Bergsten (2004) and Truman (forthcoming 2005); subsequently Bradford and Linn (2004) made a similar proposal.

rations of the LEMs for a seat at the global economic policy table. It would also contribute to an important efficiency gain if the present G-7/G-8 structure of meetings were to atrophy.[11] On the other hand, informal caucuses would persist. The G-7 is likely to play an informal coordinating role for a period.[12] However, the United States should also use the G-20 to encourage the five principal LEMs to take on greater responsibility for the health of the global system in return for having their own concerns addressed more fully.

As was the case in the early days of the G-10, which included countries in deficit as well as those in surplus, the economic and financial circumstances of the G-20 countries are not identical.[13] The G-20 brings together the representatives of the right group of countries to address issues of macroeconomic stabilization, including the policies of the individual G-7 countries—which have tended to receive a free pass in most G-7 discussions in recent years—and the macroeconomic policies of the LEMs themselves. The coverage of G-20 activities would include not only issues directly affecting economic prosperity and financial stability but also other issues with indirect effects such as private-sector development, multilateral finance, health, education, poverty reduction, environment, energy, and some aspects of trade issues.[14]

If the G-20 is to be transformed from a discussion forum into an action committee, the United States will have to take the lead to convince other G-7 countries that this is the way to go. Although the G-20 would continue to be a forum for information exchange, dialogue, and mutual education, in its enhanced form it should endeavor to reach concrete agreements on common objectives and to make joint commitments to take coordinated actions. Today those objectives and actions would be expected to cover modifications of exchange rate policies, smooth adjustment of global external imbalances, and a focus on major debt cases, such as Argentina and Turkey. The representatives of the relevant countries would be taking part in the discussions. In some cases—for example, exchange rate policies—actual decisions might involve a smaller group of countries but, as in the case of the Plaza Agreement in 1985 with respect to the G-5, the G-20 could in advance promote and later support those decisions.

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11. The G-8 includes Russia and is a political group, not an economic and financial group, that meets at the summit level.

12. As Lardy suggests in his chapter, during a transition period, the G-7 may want to invite China to participate in some of its deliberations, as occurred on an ad hoc basis on October 1, 2004.

13. The G-10 includes the G-7 plus four small European countries: Belgium, the Netherlands, Sweden, and Switzerland.

14. The G-20 should not take over trade issues from the WTO, but it could lead by exhortation. For example, the communiqué issued following the G-20 meeting in October 2003 in Morelia, Mexico—a month after the inconclusive Cancún meeting of WTO ministers—endeavored to give a boost to the Doha Round.

Most importantly, the G-20 also needs to focus its energy on the aspirations and objectives of the LEMs. These include dealing with four key issues: first, infrastructure financing and rural development so that these economies can better integrate their marginal economic areas into their own economies and world markets by having access to resources beyond those afforded by the market, IFIs, corporations, NGOs, and foreign aid. An approach similar to the European Regional Development Program comes to mind. Second, sustained poverty-reducing growth that involves an evolution of the orthodoxy of the Washington Consensus to include flexibility in the area of structural adjustments and a focus on poverty programs, as currently advocated, albeit not fully and successfully implemented, by the International Monetary Fund (IMF) and World Bank. Thus, it would be an appropriate outlet for elaborating the development assistance strategy as it applies to these countries, outlined by William Cline and John Williamson in their chapter in this book. Third, technical and possibly financial resources aimed at correcting institutional and fiscal weakness at all levels of government within individual LEMs. Fourth, political support for regional economic groupings led by individual LEMs such as Mercosur, the Southern African Development Community, and the Association of South East Asian Nations (ASEAN) free trade area. The United States should support regionalism and regional groups as long as they do not impede future cooperation with existing groups or the nondiscriminatory participation of third parties in the economic opportunities in those regions.

The new G-20 should evolve in several dimensions. It should meet more often than the current once a year. Greater use should be made of working groups to study specific problems of common interest. The G-20 deputies should become more involved in monitoring the implementation of decisions than in talking about alternatives. The new G-20 might establish a permanent secretariat, replacing the rotating national secretariat of today. An efficiency gain would be achieved by consolidating EU representation into one seat, but this would be difficult to accomplish. In due course, starting perhaps with ad hoc meetings, the G-20 could become the new framework for summit meetings, replacing the G-7/G-8 summits, but we favor starting at the level of finance ministers and central bank governors to increase the probability that the group will deal with substantive economic and financial issues.[15]

More generally, an enhanced G-20 would provide impetus to the trend to include important emerging-market economies on international standard-

15. Canadian Prime Minister Paul Martin proposed on May 10, 2004, the establishment of a G-20 at the level of heads of state while retaining the G-8. His proposal built on work of the Canadian Centre for International Governance Innovation and Centre for Global Studies (2004). They have looked at the case for a G-20 at the level of leaders, but neither Martin nor the Canadian research institutions specify which 20 countries they would include in their G-20.

setting bodies such as the Financial Action Task Force (FATF), which sets standards for dealing with money laundering and the financing of terrorism, and the Basel Committee on Banking Supervision, which sets international banking and capital standards.[16] We recommend providing LEMs with a rotating seat on the Financial Stability Forum, which consists of finance ministry, central bank, and regulator representatives from the G-7 countries; representatives from the standard-setting bodies; representatives from a few key markets (for example, Singapore, the Netherlands, Hong Kong); and representatives from the IFIs, including the Bank for International Settlements (BIS) and a couple of its committees.

Some might favor the International Monetary and Financial Committee (IMFC) of the IMF replacing the G-7 in these roles. Three arguments against such an approach can be made: (1) The IMFC has had a dismal record in economic policy coordination, in contrast with guiding the policies of the IMF itself; (2) most members of the IMFC are constrained to represent the views of their multicountry constituencies rather than their own; and (3) the G-20 would be better placed to address broader economic policy and related issues than the IMFC, which is dominated by the IMF bureaucracy and focuses primarily on issues where the IMF plays a major role.

Partly for this last reason, a need to address a broader range of issues, Kenen et al. (2004) have recommended the establishment of a Council for International Financial and Economic Cooperation (CIFEC) with standing and term members. They argue it would have greater legitimacy, accountability, and representativeness than the existing G-20. They also propose that the CIFEC have a broader mandate to cover economic issues. However, Kenen et al. are vague about where that mandate would come from in order to provide more legitimacy than the G-20 now has. It is unclear how much more representative their CIFEC would be than the G-20. Moreover, the G-20 exists today, and it would be better to enhance it than to add another body, as the world does not need yet another supercommittee![17]

Recommendation 2: Redistribute IFI Chairs and Shares

The LEMs have major interests in the structure and functioning of the IFIs: the IMF, the World Bank (International Bank for Reconstruction and De-

16. The FATF has targeted China and India for membership once their anti–money laundering regimes are judged to be sufficiently robust in design and implementation.

17. We considered the alternative of streamlining the membership of the G-8, by reducing European representation and adding China and perhaps one or two other LEMs from the inner circle to a newly created "super G." This idea has some merit but would be very challenging to implement. Unfortunately, on issues of world economic governance, one does not have the luxury of starting with a blank sheet of paper. We see a more immediate payoff in working with what is already available in the form of the existing finance G-20.

velopment), and the regional development banks (RDBs). For the LEMs, these institutions are sources of financial resources, policy advice, professional expertise (including the training of their own officials), and influence. The LEMs long have clamored for more voices and votes in them.

The United States should use its considerable influence to support these aspirations.[18] The principal means to do so is to reduce the representation of old and new EU members on the IMF executive board; see Truman (2004). These 25 EU countries now appoint, or play a major role in the election of, 10 of the 24 members of the IMF executive board. Seven of the 24 executive directors and 8 of the 24 alternate executive directors are nationals from these countries. EU members directly control 32 percent of IMF votes.[19] They potentially control an additional 12.5 percent of the votes of EU nonmembers. The decision-making process in the IMF executive board is primarily one of consensus, in which the number of speakers in the room is important. Currently, European voices are heard disproportionately, and that excess tends to bias IMF decisions, for example, in the direction of limiting the scale of financial assistance to countries in Latin America and East Asia.

The United States should seek agreement from the EU countries, first, to drop from their IMF executive board constituencies all EU nonmembers, reducing the number of EU first-row or second-row chairs below 10 to at most five or six.[20] Second, the EU countries should consolidate their chairs into one appointed chair.[21] As a consequence, the size of the executive board could be shrunk to its original 20 seats by reducing the EU seats by a further five or four, freeing up five new seats for LEMs and thus achieving broader representation on the board.

As part of this overall agreement, the United States should support a reduction of the combined EU share in IMF quotas, which is justified based on traditional quota formulas, because about half of their trade is now internal to the European Union. If the EU quota share were reduced from its current 32 percent to the US 17.5 percent, or perhaps a bit higher at 20 percent, the LEMs, many of which have ample reserves, could be granted substantial quota increases out of the combined 10 to 15 percent share of

18. The precise details of this recommendation apply to the IMF, but a parallel argument can be made for the World Bank and, to a lesser extent, the RDBs.

19. The 10 members that joined the European Unions in May 2004 have 2.1 percent of the votes.

20. EU members now have the majority of votes in five IMF constituencies, including three appointed directors and alternates. In one other constituency, the Netherlands has the largest number of votes and the European Union almost a majority adding Cyprus. We are assuming that the European Union would consolidate into these five or six chairs and not seek to displace any other chairs.

21. Representation of the European Central Bank (ECB) on the IMF executive board could be achieved by having the alternate executive director come from the ECB.

quotas that would be released. Thus, both the voice and the vote of the emerging-market economies would be enhanced.[22]

The United States has considerable leverage in this area, which it should use judiciously in support principally of the aspirations of the LEMs. As long as the IMF executive board is larger than the 20 seats mandated in the IMF Articles of Agreement, a vote is required every two years to maintain its size. That vote requires an 85 percent majority, which means US support is required to maintain the current 24 seats. Thus, the United States should make it clear to the Europeans that progress is expected on this issue in the IFIs. If progress is not made, the United States should hold the Europeans responsible for the actions the United States would be forced to take with respect to contracting the size of the IMF executive board. The United States also could consider offering to support a move of the headquarters of either or both the IMF and/or World Bank to a European capital, which would be consistent with the provision in their charters that their headquarters are in the country with the largest quota, to entice the Europeans to embrace this recommendation. Of course, a relocation would be potentially costly and highly disruptive to the organizations and the lives of their staffs.

Recommendation 3: Reorganize US Policymaking Toward the LEMs

At present, US policy toward the LEMs is not developed and implemented in recognition of the extensive common interests among these countries in their relations with the United States. US policy toward each of these countries flows either from a regional orientation—Brazil is part of Latin America—or on an ad hoc basis—Brazil faces a major crisis and a mechanism needs to be developed to deal with that crisis. We recommend a restructuring of the US intra-agency and interagency policy apparatus in recognition of the need to develop and implement a set of consistent and unique policies toward the LEMs.[23] We outline below the procedural steps to implement our recommendation, some of the challenges, and one payoff in the area of US policy toward regionalism.

The initial step in this restructuring process would be to issue a presidential executive order instructing the relevant parts of the government to propose the actions each will take to reorganize itself in a manner that will address the challenge of a coordinated policy toward the LEMs. This executive order would include the appointment of a "coordinator for large emerging-market economies," with the rank of senior director, dual-

22. A similar allocation of seats could occur at the same time in the World Bank and the RDBs, but the reallocation of capital subscriptions would have to be spread over a longer time period so as not to endanger the banks' credit standing.

23. Garten (1997) points out the extent of compartmentalization that exists within the US government and its adverse effects on the formulation and implementation of a comprehensive strategy toward LEMs.

hatted from the National Security Council (NSC) and National Economic Council (NEC) and reporting directly to the national security adviser and the head of the NEC.

Initially, the coordinator would be charged with the task of determining, in consultation with Congress and the Office of Management and Budget, the responsibilities of each part of the government, including the identification of synergies and elimination of any overlaps. A three-month deadline should be set for the completion of this analysis, and the threat of presidential action without consultation would help to limit interagency or executive-legislative branch squabbling. When completed, this blueprint would describe the formal interagency consultative and decision-making process that would generate, on an ongoing basis, a focused and coordinated policy toward the LEMs. The final step would be to propose its approval by the principals of the NSC/NEC in the form of a national security directive.

Turning to some implementation challenges, a decision-making process focused on policy toward the LEMs would be catalytic in the larger departments, for example, State, Treasury, and Commerce, which tend to look at issues in regional or intraregional terms but not global terms. In the case of the quasi-independent agencies such as the Export-Import Bank and the Overseas Private Investment Corporation, countries and regions end up reporting to functional or product areas, creating a further challenge to a LEM-focused strategy. In addition, the reorganization might help to rationalize resources now devoted to the panoply of institutionalizations of bilateral US relations, for example, the US-(country) forum, commission, committee, or dialogue.[24] These entities are usually launched as a "deliverable" in the context of a presidential visit to or from the country and later fall into substantive disuse as they use up resources.

However, even in smaller units, such as the NSC/NEC and the Council of Economic Advisers (CEA), it would be desirable to think of organizing staff responsibilities for the LEMs as a group. At the CEA, for example, a priority might be placed on choosing a member who has extensive experience in the policies and problems of emerging-market economies.[25] As Destler (1996) has analyzed, another dimension of the implementation challenge will have to do with the NSC's historic inability to give economic issues adequate weight and with the removal of control of LEM-related international economic issues from the NEC, thus severing the link between domestic and international economic policy. At the NSC currently, each of the LEMs is looked after by a separate senior director, who, in turn, has one person responsible for economic issues and one responsi-

24. Of the 11 LEMs that are the focus of our attention, at least six, in principle, have some form of annual, high-level bilateral forum, dialogue, or partnership on economic and financial issues with the US government: Brazil, China, India, Mexico, Russia, and Turkey.

25. Kristen Forbes, a member of the CEA in 2004, fits this profile.

ble for several countries within a region (e.g., the southern cone of Latin America, which includes Brazil). As situations arise, teams are assembled and tasked with interacting with different parts of the executive branch and with formulating recommendations for the principals of the NSC. Today, there is no dedicated, senior-level group or effort focused on the LEMs, in particular one able to be proactive and with access to decision makers. Our approach would imply a reallocation of personnel and reorganization of the NSC so that continuity and focus on the LEMs is ensured.

In the interagency process, it would be desirable to establish a staff-level working group on the LEMs that would help to develop and coordinate common policies to deal with their problems and meet their needs, presumably under the leadership of the NSC/NEC senior director for large emerging-market economies mentioned above. This approach would have several advantages. It would tend to promote common solutions to common problems, rather than ad hoc country-specific solutions, thereby providing greater consistency to US policy.[26]

Not only would policy be more consistent but also proactive policies might be developed and presented for this set of important countries as a group. Moreover, reduced reliance on ad hoc policies would tend to depoliticize at least their presentation, recognizing that political and strategic interests would always come into play. In implementing this approach, care needs to be taken not to usurp the traditional policy leadership of a given department or agency (for example, policies on debt rescheduling at Treasury and foreign assistance policies at State) so as not to create a low-level but paralyzing bureaucratic territorial war (Juster and Lazarus 1997).

This reorganization of intra-agency and interagency work with the LEMs would tend to reinforce the enhanced role of the G-20 recommended above and vice versa, just as the establishment of the finance G-5, later G-7, was helpful in guiding the federal bureaucracy in developing common policies toward the G-5/G-7 countries. These changes will encounter resistance, yet the rationale for them is clear: to identify and realize the knowledge synergies within the White House and the executive branch and to have a consistent policy relating to the LEMs.

An important benefit of the refocusing of US foreign economic policy toward LEMs involves the US government's position—or lack thereof—on regionalism. The United States historically has been a promoter of regional economic and financial arrangements, for example the European Common Market in the 1950s and the North American Free Trade Agreement.

26. To cite an example from the past, the approach taken toward a current financial crisis in Brazil would be developed in the context of the approach taken in a prior crisis in Korea. That this is not occurring systematically is illustrated by Korean complaints that greater demands were placed on their country in 1997–98 than were placed on Brazil in 1998–99 in connection with their respective IMF-supported programs.

More recently, the United States has been somewhat ambivalent about regional groups in which it is not included. For example, it has been a skeptic about, if not in open opposition to, former Malaysian Prime Minister Mahathir's proposed East Asian Economic Group and later the Japanese-proposed Asian Monetary Fund (Henning 2002).

In particular instances, US positions have been influenced by strategic or political considerations as well as economic considerations—for example, damage to US exports. The US attitude also has been affected by the potential adverse impact of new regional institutions on existing global institutions. For example, the Asian Monetary Fund was seen as a rival to the IMF with its near-universal membership. It had and still has the potential to undermine the IMF's influence and at the same time to complicate the implicit rules and understandings guiding the functioning of the international financial system as a whole with respect to flexibility of exchange rates and capital movements.

In the future, it would be useful for the United States to articulate the standards it intends to apply in evaluating regional arrangements in which it does not participate. Subsequently, the United States should support those regional arrangements that meet its standards. Less controversial examples might be India's desire to build bridges to the Association of Southeast Asian Nations (ASEAN) and Turkey's efforts to become part of the European Union. On the other hand, an example of a regional arrangement that would require hard, unbiased analysis on the part of the US government would be China's interest in creating an East Asia Community similar to the European Union.

This approach would be analogous to establishing, at the level of national policy, self-disciplines such as those found in GATT Article XXIV and GATS Article V with respect to free trade areas (Schott 2004). Unfortunately, those multilateral disciplines have not worked very well, and similarly the task of articulating criteria for self-discipline may be too difficult because of the actual or perceived sui generis nature of each regional proposal. However, the effort, in particular if it were conducted in a relatively open and transparent manner, might earn the United States points with the LEMs that tend at times to be mystified by why the United States takes the positions it does on these matters. It might also help to provoke a healthy debate within the United States about the place of regionalism in the world of the 21st century.

Active Collaboration Between the United States and LEMs

We now address the opportunities US policymakers have to work in collaboration with the LEMs. We organize our recommendations under two headings: (1) poverty-reducing economic growth and (2) crisis resolution and global financial stability.

Poverty-Reducing Economic Growth

The dominant interest of the LEMs is sustained economic growth to raise their standards of living on average and to reduce the incidence of poverty. The United States, along with the European Union and Japan, should respond more effectively to this overriding interest. We suggest below three areas where the United States could work with the LEMs to achieve their objectives via the promotion of initiatives in private-sector development and increased cooperation on development issues and on tax evasion.

Recommendation 4: Undertake Initiatives in Private-Sector Development

It is fashionable to emphasize microeconomic objectives in the context of US foreign economic policy. Yet the ability of government policy to promote private-sector contributions to economic development in the world remains limited.

In the financial sector, the crisis-prevention pillar of the improved international financial architecture developed over the past decade or so has placed substantial emphasis on the development of international standards and codes, surveillance of compliance with those codes, improved data provision, and increased transparency. On the other hand, in the sectors producing goods and services (sometimes referred to as the "real economy"), US government policy has been, at best, a passive, reactive participant and, at worst, a verbose but not particularly useful enabler. This is particularly true for small and medium-sized enterprises (SMEs), which are particularly relevant to development given that small firms and entrepreneurs are the main source of innovation and employment creation in both industrialized and emerging-market economies.

Promotion of private-sector development in the LEMs requires US policymakers to focus on the issues that most stand in the way of growth and development both within LEMs and between them and the United States. Among these issues are competition policy, governance, regulation, corruption, legal streamlining and cost reduction, and removal of other impediments to private-sector growth or threats to the integrity of the financial system. Competition policy includes antitrust issues within countries and barriers that prevent the efficient allocation of resources across borders. Regulatory capacity building needs to be provided to the LEMs so that major inputs into the productive sector are priced in the interests of consumers as well as investors. Finally, differences in legal standards, degree of litigiousness, and arbitration and enforcement capabilities within and between industrialized countries and emerging markets remain a monumental barrier to private-sector development.

The private sectors in LEMs require partnership opportunities (for example, marketing and distribution), local financing alternatives, and ac-

cess to technology broadly defined. Their SME sectors finance themselves primarily with internally generated funds and desperately need access to local, long-term financing that is competitive with larger players. The G-8 has identified remittances and microfinance as very important sources and uses, respectively, of capital for the SME sector in developing countries. The challenge for the G-8 and the multilateral institutions, as their implementation agents, is how to achieve meaningful and measurable results. This area might represent a nice opportunity for partnership between the government and the private financial sector. What can financial-sector institutions in both industrialized and emerging economies do to promote widespread lending to entrepreneurs in LEMs on terms comparable to their peers in developed economies? What can the G-20 financial policymakers do to promote access and openness within each other's financial markets?

From the vantage point of industrialized countries, access to the LEMs for their small business sector is of high interest. US policy needs to foster concrete enabling factors (for example, tax incentives and financing) to make this a compelling and more accessible opportunity.

The issues identified by the emerging-market economies do not always coincide with the views of the United States or other industrial countries—for example, not placing sufficient emphasis on anti–money laundering or on combating the financing of terrorism. In these areas, it would be appropriate for the United States to support or supply technical assistance, including the financing of institutional changes, in support of the achievement of objectives that involve important global public goods but whose availability is limited in emerging-market economies.

Recommendation 5: Increase Cooperation on Development Issues

Many LEMs continue to rely heavily on borrowing from the World Bank, the RDBs, and on a less sustained basis from the IMF. At the end of 2003, these institutions had $231.9 billion outstanding to 10 of the 11 LEMs that are members of the G-20.[27] This group of countries includes ones that are making net repayments or are no longer borrowing from the banks, such as Korea, as well as countries that have recently graduated from International Development Association (IDA) eligibility, such as China, and countries that are currently blend borrowers from IDA and the World Bank, such as India and Indonesia. The United States has a shared interest in increasing its cooperation with the LEMs in development lending. Three steps should be considered.

First, as sketched out earlier, the United States should support a more meaningful voice for the LEMs in the direction of the development banks.

27. Saudi Arabia has no obligations to the multilateral development financial institutions.

Also in the common interest is promoting a gradual transition from the status of borrowers from those institutions to the status of financial supporters of them, via progressively increasing their costs of borrowing from them and other means.

Second, the more advanced LEMs should retain the scope to borrow from development banks in certain circumstances. Those circumstances should include periods of external financial crisis, as was the case for Korea in 1997–98, in particular to provide fiscal support for the continuation of social programs. They should also include limited support for public and private infrastructure investment in periods where the countries are operating under tight fiscal constraints. On the other hand, a delicate balance has to be struck between the buildup of government debt, especially to preferred creditors such as the IFIs even when the interest cost is lower, and the restoration of debt sustainability.

Third, the United States should explore foreign assistance partnerships with the LEMs. These partnerships should have the objective of increasing the efficiency of existing delivery mechanisms and the encouragement of contributions or increased contributions to the soft-loan or grant windows of the development banks, such as IDA in the World Bank Group or the Fund for Special Operations in the Inter-American Development Bank (IDB) or the Multilateral Investment Fund of the IDB, which supports private-sector development with an emphasis on the small and microenterprise sector.

These partnerships should also involve joint bilateral assistance programs for individual countries or regional groups in which a substantial share of the funding would come from the United States or other industrial countries, but the LEM partner countries could provide expertise and delivery systems based on their own experiences. In addition, greater effort should be made to consult and coordinate aid disbursements among major donors to avoid duplication and competition.[28] The G-20 should establish a one-stop shopping and clearinghouse for recipients of bilateral aid. This initiative could be blended with the process of graduating the LEMs from borrowing from the development banks by actively encouraging them to take on greater global leadership responsibilities.

Recommendation 6: Increase Cooperation on Tax Evasion

Dependence on foreign investment, borrowing, and aid is to some degree due to the inability of many LEMs to collect taxes from their citizens and corporations. The United States has played a global leadership role in

28. The issue of aid project proliferation has been a focus of considerable criticism (Roodman 2004). Birdsall and Deese (2004) point out that this phenomenon diverts the time and attention of officials in recipient countries from broader and more persistent problems of governance.

combating financial crimes. One area of substantial attention has been the global anti–money laundering regime, and most recently the use of that regime to reduce and disrupt the financing of terrorism (Reuter and Truman 2004). The LEMs do not all attach the same high priority to these objectives though many of them are increasingly concerned about the integrity of their financial systems. For the United States, the achievement of these goals is a necessity; for many other countries they are luxuries. A quid pro quo for help in achieving US objectives in this area would be to pursue with the LEMs the "shared" objective of reducing tax evasion.

Many LEMs are very concerned about tax evasion. In Latin America, in particular, saving rates are low and fiscal resources are scarce. Historical patterns of capital flight are engrained, which deprives countries of tax revenues on income from investments abroad. These weaknesses contribute to excessive foreign borrowing by the private and public sectors and to external financial crises. The United States has an interest in helping these countries deal with tax evasion analogous to the US interest in facilitating the flow of remittances at lower costs to the private sector.

Today US international cooperation on tax evasion with most countries, including the LEMs, is limited. Tax evasion in the United States or abroad is not a basis for US anti–money laundering prosecutions. Bilateral tax treaties generally provide for the exchange of information, but the procedures are cumbersome and the scope of the provisions does not extend to operations of US institutions outside the United States—for example, islands in the Caribbean—with which the home country has to have an additional layer of legal arrangements.

On the other hand, the United States has put into place mutual assistance arrangements with other industrial-country jurisdictions, such as Australia, Canada, and the United Kingdom, to combat abusive tax avoidance transactions. Similar arrangements should be put in place with interested LEMs. In addition, the United States should make common cause with them to establish an international tax organization, as suggested by former Mexican President Ernesto Zedillo's panel on the mobilization of resources for development (United Nations 2001). This organization could start with the collection and sharing of statistics and information on problems and also provide technical assistance. The ultimate goal might be to achieve international agreement on the comprehensive sharing of tax information and better convergence in the tax treatment of multinationals.

One should not be too sanguine about achieving rapid progress in this area. The experiences of the Organization for Economic Cooperation and Development (OECD) on reducing harmful tax competition and of the European Union in endeavoring to agree on its savings directive have involved years of negotiation and, in the EU case, may still fail to establish an admittedly second-best accord if Swiss voters block the new Swiss-European treaty that covers this area, among others. Nevertheless, the United States as well as Europe and Japan could create valuable bonds

with emerging-market economies if they upgraded cooperation on tax evasion with the LEMs.

Crisis Resolution and Global Financial Stability

Most of the LEMs have experienced one or more external financial crises over the past 15 years, some of which have not yet passed.[29] Even with the widespread adoption of more flexible exchange rate regimes, improved macroeconomic and structural policies, and greater transparency, only a fool would wager that over the next decade none of the LEMs will experience new crises requiring substantial ex post international financial support. The United States should adopt policies that recognize this reality. In addition to continuing to support economic reform and macroeconomic stability in these countries, the United States should endeavor through the refocused G-20 as well as other channels to establish consensus on a proactive framework for crisis resolution, including actively exploring alternative means of providing financing for countries in crisis, and support a resumption of regular annual SDR allocations.

Recommendation 7: Create a Proactive Framework for Crisis Resolution

The most severe economic and financial effects of financial crises can be ameliorated somewhat by better prevention policies, but they will not be eliminated. The recent policy of the United States combines the rhetoric of limited access to IMF financing with actions that result in the provision of increasingly large access to IMF financing without a clear rationale for doing so (see Morris Goldstein's chapter in this book). It is unrealistic to take the firefighter out of the game; meanwhile the gap between what the United States says and what it supports is widening, sowing uncertainty among the LEMS about US policy intentions. The LEMs, the United States, and the global economy need a realistic, constructive, proactive strategy for crisis resolution.

Roubini and Setser (2004) provide a comprehensive review of experience over the past dozen years with the resolution of external financial crises and a framework for dealing with future crises. The key elements of the Roubini-Setser framework are (1) distinguishing promptly between liquidity and solvency crises, (2) adopting appropriate adjustment measures to match external financing with the nature of the crisis, (3) using large-scale IMF financing for a variety of purposes, including in conjunction with coercive debt restructuring as necessary, (4) avoiding the trap of

29. Of the 11 emerging-market economies in the G-20, only Saudi Arabia has not received IMF financial support for its economic policies over the past two decades, although the possible need was considered in the mid-1990s. China borrowed from the IMF in 1986 and made its last repayment in 1992.

countries that are too strategic to fail, and (5) recognizing that the IMF has a central coordinating role in the management of crises.

Taken as a package, this set of recommendations, with the proper support, political and financial, would substantially rationalize the process of resolving external financial crises. This framework for crisis resolution should be adopted by the US government, explained to and examined with representatives of the emerging-market economies, and promoted in bodies such as the G-20, IMFC, and IMF executive board.

The need for external financing in the resolution of crises is likely to increase in the future because of nominal growth and the fact, documented in Roubini and Setser (2004), that the financing provided in some cases in the past has been too skimpy, while in other cases international financial support has been too generous for too long.

One approach to meeting the reasonable financing needs of countries in crisis is through the more aggressive use of a coercive bail-in process. A second approach is to augment the IMF's traditional quota resources for use to support adjustment programs, which will almost certainly be desirable at some point over the next three to five years. A third, largely complementary, approach is to augment emergency funds available to the IMF via the New Arrangements to Borrow (NAB) from a subset of IMF members, including importantly the United States and six emerging-market economies (Chile, Hong Kong, Korea, Malaysia, Saudi Arabia, and Thailand). These six economies were included in the NAB in 1996 because at that time they were perceived as having the financial capacity to provide resources to the IMF in addition to their quota subscriptions. It would be appropriate for the other 9 of the 11 LEMs that are members of the G-20 to join the NAB as well.

It is possible that these approaches will prove not to generate sufficient resources, or they may founder on political opposition to them. Therefore, consideration should be given to alternative sources of financing to and through the IMF. For example, Truman (2001) proposed the establishment of an International Financial Stability Fund (IFSF) that would be financed by annual fees on stocks of cross-border investments and could be tapped under certain circumstances to finance in whole or in part large programs of IMF financial support. While this may not be the most attractive or saleable alternative financing mechanism, it has the advantage of prepositioning financing from the private sector that can be disbursed, in part, for the benefit of the private sector.

Recommendation 8: Resume Regular Annual SDR Allocations

SDRs are reserve assets issued by the IMF. There have been two issues of SDR, in 1970–72 and 1979–81, for a total of SDR 21.4 billion ($33 billion), and under the pending fourth amendment of the IMF Articles of Agreement an additional SDR 21.9 billion ($34 billion) would be issued. The

amendment was approved by the IMF's Board of Governors in 1997 and has been ratified by enough members that it will go into force as soon as the US Congress ratifies it.

The original rationale for the SDR mechanism, as a supplementary reserve asset to stabilize the international monetary system, and a briefly acquired rationale, as the principal reserve asset in place of gold in an international monetary system of fixed exchange rates, are no longer relevant to the smooth functioning of the international monetary system that features the widespread adoption of more flexible exchange rate regimes, the de facto phasing out of gold, and the ready access of major countries in most circumstances to borrowed liquidity. However, a case can be made that the resumption of SDR allocations on a regular, annual basis would benefit the functioning of the international monetary system (Clark and Polak 2004). Moreover, the resumption of SDR allocations at the rate of, say, 10 percent of IMF quotas per year would be welcome by most LEMs.

The case against resuming SDR allocations rests on several arguments. First, SDR allocations, it is argued, would add to global inflation; this argument is no longer, if it was ever, relevant to current economic conditions. Second, the allocations would go to the wrong countries, encouraging them to delay necessary adjustment measures; this would not be the case if annual allocations were small. Third, the allocation of SDRs is inconsistent with an international monetary system based on floating exchange rates in which it is unnecessary to hold reserves.

The facts fly in the face of the third argument in particular. The 11 LEMs that are members of the G-20 have increased the ratio of their international reserves (excluding gold) to GDP from 4.2 percent in 1990 to 13.7 percent in 2003.[30] Over the same period, the average ratio of reserves to imports rose by 30 percentage points. The present form of reserve increases is inefficient and costly; the cost of borrowing reserves is larger than the return on holding them, whether the reserves are accumulated through sovereign borrowing or private capital inflows. In addition, reserve accumulation via larger current account surpluses or smaller current account deficits requires the use of real resources that can be better applied to domestic investment and consumption. Moreover, those larger surpluses or smaller deficits distort the adjustment of international payments imbalances.[31] Exhibit A for the last proposition is the huge defensive accumulation of reserves by China and other Asian economies in the wake of the Asian financial crisis and the reluctance of China and other

30. Because we lack comparable data for Russia in 1990, we have excluded that country from these calculations.

31. Clark and Polak (2004) argue that in addition to global efficiency gains from greater reliance on SDR as reserve assets, the stability of the international financial system would be enhanced because of reduced reliance on borrowed reserves, which need to be refinanced; the availability of such financing is subject to sudden stops if market conditions change.

emerging-market economies to allow their exchange rates to adjust lest they slip back into current account deficit. By recognizing the reality of the LEMs' desire to increase their reserves and by supporting a resumption of SDR allocations, which the LEMs also favor, the United States would buy some influence over these countries' decisions with respect to their exchange-rate and reserve-accumulation policies, which would improve the functioning of the international adjustment process.

Thus, the United States as well as emerging-market economies should welcome the resumption of SDR allocations on a regular annual basis. The United States would also demonstrate to the emerging-market economies and the rest of the world that it takes its international financial agreements seriously by ratifying the fourth amendment of the IMF Articles of Agreement. Both steps would lay the groundwork for the possibility of special large SDR allocations, largely as a symbolic action, if concerns about global deflation again emerged, or the cancellation of SDR if global inflation threatened to get out of hand.

Budgetary Reality Check

Because of the large US budget deficit, the US government over the next four years and beyond most likely will be operating under a severe budgetary constraint. The risk is that pressures to cut the budget deficit will lead to a disproportionate cutback in official US external financial operations, which some would argue have been shortchanged in the past. This could adversely affect US external interests at the same time that the small absolute size of the cutback has little effect on the overall US budgetary position. Even if such a near-sighted posture is avoided, the reality will be tight budget resources. Therefore, in the spirit of responsible policymaking, we provide a reality check on our eight recommendations by summarizing them from the standpoint of their impacts on the US federal budget. The basic budgetary impacts fall into two categories: negligible and small.

Five of the recommendations would have negligible impacts on the budget.

- Recommendation 1, replacing the finance G-7 with a refocused G-20, would involve only a reallocation of existing US personnel resources from G-7 activities to G-20 activities.[32]
- Recommendation 2, redistributing IFI chairs and shares, would have no cost to the United States and might provide financial benefits over time if the LEMs were encouraged to graduate more rapidly from bor-

32. If the refocused G-20 took up our suggestion for consideration of a program of regional development assistance on the EU model, this might involve substantial amounts of budget resources unless current expenditures were reprogrammed.

rowing from the development banks and become net providers of support for these institutions.[33]

- Recommendation 3, reorganizing US policymaking toward the LEMs, also would involve only a reallocation of existing resources along with the promise of some efficiency gains.
- Recommendation 6, increasing cooperation on tax evasion, should pay for itself if the United States can bring itself to embrace such an initiative.
- Recommendation 7, creating a proactive framework for crisis resolution, should not involve an additional US financial commitment to the IMF compared with the realistic alternative, which is that an increase in IMF quotas is likely to be required at some point over the next three to five years. By involving some of the LEMs in the NAB and exploring alternative devices to finance the IMF, the US financial contribution—which technically does not now involve budgetary outlays, but is a budgetary issue—might be smaller than otherwise. Moreover, existing and potential resources might be more efficiently spent to resolve external financial crises than has been the case in recent years.

We now turn to recommendations where the implications for the US federal budget would be nonnegligible but small.

- Recommendation 4, promoting initiatives in private-sector development, would involve legislative and regulatory initiatives to accompany actions taken by the private sector itself. It might require some modest additional expenditure for technical assistance if resources could not be reprogrammed from existing less effective programs. Any cofinancing or colending to private-sector institutions would be done above the US government's cost of funds and would take into account appropriate risk premiums.
- Recommendation 5, increasing cooperation on development issues, could require an increased US financial commitment in this area over the near term (three to five years), but that commitment might be compensated down the road as the LEMs graduated more rapidly from the status of borrowers, to making net repayments, and finally to the status of important financial contributors. In addition, increased funding is already contemplated as part of the new Millennium Challenge Account initiative that, if anything, is suffering from disbursement not funding challenges.
- Recommendation 8, resuming regular annual SDR allocation, would involve a small net budgetary expense to the extent that the interest

33. In the unlikely event that the headquarters of the IMF or the World Bank were relocated from Washington, there would be substantial expense for those institutions, and the United States might condition its support on not participating in covering them.

rate on US net holdings of SDR (in excess of our allocation) exceeded the average cost of US borrowing. However, the projected amounts would be small.

Our conclusion is that our recommendations not only provide the framework for constructive US policy toward the LEMs but also are fiscally responsible.

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