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THE IMPACT OF THE FINANCIAL CRISIS ON LOW-INCOME COUNTRIES

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P R O C E E D I N G S

MR. TALBOTT: Good morning, everybody. I'm Strobe Talbott. It's my great pleasure to welcome you here to Brookings on a sunny, but pretty chilly day.

On behalf of the Brookings Program on Global Economy and Development and its Director, Lael Brainard, who's with us this morning, it's my particular honor to welcome Dominique Strauss-Kahn, the Managing Director of the IMF, here to Brookings. I'm also very pleased that his wife, Anne Sinclair, could be with us. She and I are fellow journalists, although she's still a practicing one. I asked her if she was going to write up Dominique's speech today, and she said she'll see.

Dominique's visit here to Brookings could not be more timely for a number of reasons that I think you can all easily imagine. The financial crisis is on everybody's mind here in the city and in this country. The headlines, of course, are all about the stimulus package, the bailouts, the multiple economic and political debates that swirl around these issues, and also as of this morning, the latest nose dive in the Dow Jones. But for Americans, this whole crisis is so preoccupying in its national dimension that we need reminders from time to time about the international dimension of the crisis. And more specifically, we need reminders on the extent to which other countries are suffering more than our own. And that notably includes countries unlike ours that bear little or no responsibility for the disaster that has befallen them and the greater catastrophes that they face unless there is an effective, multilateral response. This, I think it is fair to say, is not a scenario that the founders of the international financial institutions had in mind when they met at Bretton Woods 65 years ago.

With the threat to low-income countries very much in mind, the IMF is hosting a very important conference in Dar es Salaam next week. Dominique is going to offer some opening remarks, and then we're going to move to a panel discussion that is going to involve three Brookings scholars: Eswar Prasad, Mauricio Cárdenas, and Homi Kharas. The panel will be moderated by Bill Antholis who has the imminent title of Managing Director here at Brookings. Bill and Dominique go back a long way to a project that they worked on together on the connection between free trade and international development. Bill is now also coordinating a startup of a new, major, multi-year Brookings project on the financial crisis in all of its dimensions.

But first, it's my honor to turn the microphone over to Dominique. Thank you for being with us.

MR. STRAUSS-KAHN: Well, good morning. It's my pleasure to take part in this very important discussion on the impact of the financial crisis on the low-income countries. And I would say first that I'm very grateful to Brookings Institution for hosting this meeting and to Strobe Talbott for his kind introduction.

My remarks will focus on the key messages of the new IMF study that we're just releasing today on the impact of the crisis on low-income countries. So I will start with a very sobering message. After hitting the advanced economies and then the emerging-market economies, a third wave of the global crisis is now hitting the low-income countries, the world's poorest and most vulnerable countries, and hitting them hard.

As you all know, the global economy is in the midst of a deep downturn. The recent data suggests that even the gloomy forecasts that we released last January are probably too optimistic. We're not going to release new official forecasts before mid-April, but the flavor of what we have now is showing that those forecasts of January are already outdated. And the global recovery that we expected in the last forecast to begin at the end of 2009 or the beginning of 2010 is now delayed into 2010, providing that the right policy will be implemented, that only the policy concerning the stimulus where the advice of the Fund has been almost followed, but also the policies concerning the bank restructuration on which I must say the delay a bit long. I'm not talking especially about the U.S., but when you look at what has happened last week in the European Union, you can be just a bit concerned about the speed of the coordinated response that we need.

While this crisis has taken a little longer to reach the low-income countries, the outlook of this economy is now deteriorating sharply. The problem is not so much the exposure to toxic assets. Most of those banks are immune to the financial crisis per se. But the problem is the increased exposition, integration into the global economy. Of course, from some point of view, this integration has brought many benefits. But on the other hand, it means now that the low-income countries are much more exposed than they were in the past. So our growth forecast for 71 countries eligible for concessional IMF lending is just over 4 percent for 2009, which is 2 percentage points lower than the forecast we had one year ago.

And even this forecast is probably too optimistic as I said before. In any case, in per capita terms, low-income countries may be at best at stagnation next year and for some of them, probably the possible contraction of this per capita income.

As you all know, the main impact of the crisis on the low-income countries will be through trade. Exports are projected to decrease sharply and for commodity exporters, they're facing a particularly hard hit. I foresee mounting financing problems for developing countries. The outlook for FDI in developing countries is bleak. The forecast we have is something like a 20 percent decline. It reflects, of course, investor uncertainty, and until this uncertainty disappears, there's no real hope for FDI to resume. The cost of borrowing has risen significantly, and even sometimes whatever the price the country may pay, it is just unable to find any money to borrow. Remittances are also likely to drop, and aid flows, as you know, are under stress because of budgetary pressures in developing countries. So, these two shocks, the trade shock and the financial shock, may have a major negative impact on the external finances of the poorest countries. The decline in food and fuel prices should provide enough to some countries, but many others will see the balance of payment deteriorate.

The point is that this external crisis is rapidly spilling over into a budgetary crisis. Tax revenue will shrink as growth slows and corporate profits fall. These countries will face a higher debt service from currency depravation -- depreciation -- and also from rising interest rates. For commodity exporters, the impact we forecast is about 5 percent of GDP, which is a lot. For other countries, it’s closer to 1 percent of GDP. But even in those countries, 1 percent of GDP means a lot for very poor countries.

So, I’m deeply concerned by the potential humanitarian costs of this crisis. If you look at the World Bank figures just released, they are expecting or they’re worrying about an extra 53 million people trapped at the income level which is below $2 per day. And even more chilling, also following the World Bank figures, the infant mortality may increase from 1.4 million to 2.8 million children dying between now and 2015 if the crisis persists. So we see that the social costs are going to be huge, and with social costs of this scale, of course, it raises serious concern about political stability. So the question is not just an economic question; it also becomes very rapidly a social question. And after the social question, you have the political question. And even for some countries, the risk of conflicts and war. So starting from what is only a financial crisis, we may at the end have much bigger consequences than only income and growth consequences.

For these reasons, the low-income countries have to safeguard the funds they have for education and infrastructure, while boosting safety nets to protect the most vulnerable. To do that, some transfer programs are well designed because they do a good job of reaching the poor. I'm thinking of targeted food programs or school meal programs. We have been trying to encourage countries to develop this kinds of systems just because they're perfectly tailored for the most vulnerable part of the population, and they can help mitigate the impact of the crisis.

So what can be done to avert this potential economic and humanitarian calamity? Well, the good news is that the low-income countries are in a stronger position than before. The macroeconomic conditions have improved across the board in the last decade. Growth is up. Inflation is down. Fiscal and current account deficit have declined. Reserves are higher. And debt is lower. And these successes reflect prudent policies, which have been implemented: higher aid and debt relief, including the debt relief from the IMF. The result is that some countries have scoped to accommodating the shock, even increasing spending to cushion the impact of the crisis. Those countries have achieved macroeconomic stability, have sustainable public debt, do not face financing constraints, and also some other countries like commodity exporters that have built up a fiscal cushion during the recent boom years. That’s the good news, but for most countries it’s bad news because many of them do not have fiscal space to deal with the crisis. They can adjust, making spending more efficient, strengthening revenue mobilization, but the appropriate response to the crisis needs to have a significant amount of additional concessional financing. In some low-income countries, monetary and exchange rate policies allow some room for responding to the external shock. In those countries where inflation is well controlled, there is opportunity to ease the monetary policy. Those with flexible exchange rates may be able to use them to function as shock absorbers. But in many low-income countries, inflation is still a problem, and reducing interest rates could backfire. So the same thing is true for countries with a fixed exchange rate regime, almost two-thirds of the low-income countries, and all those countries have little room to maneuver. So our analysis is that we can identify a group of 22 developing countries that face the most acute financing constraints. To keep external reserves safe, more or less at three or four months of imports, those countries need at least $25 billion in additional concessional financing in 2009, which is almost 80 percent of annual aid flows. Moreover, this group of 22 may increase, and the need for concessional financing may be higher. If conditions deteriorate further, which is likely, the number of vulnerable countries could be more than double, close to 50. You can see on this chart that the baseline we have is that the BOP shock affecting low-income countries is a little over $150 billion, with financing needs for this group of 22 close to the $25 billion I just mentioned. That’s the second green column, and the third one is this number of 22 countries. But that’s the more plausible situation. Nevertheless, there’s a lot of downside risks. And if these downside risks do materialize, then we come to the red column, and of course, you see that the financing needed is much, much higher as the number of countries to double.

So it’s clear that the financing needs are substantial, and they are very urgent. I therefore want to use this opportunity to call on the international community to provide the financing the most vulnerable countries need to preserve their hard-earned gain, and also to prevent a humanitarian crisis. Of course, the primary responsibility to me lies with bilateral donors who must ensure that the aid flows are scaled up, not down. In advanced economies, billions of dollars are going to be spent on fiscal stimulus in the financial sector restructuration. So within these huge numbers, there must be room to help the low-income countries. Let me just remind you that at the Gleneagles G8 summit, the commitment was annual aid to Africa, which had to reach $50 billion in 2010 and $75 billion in 2015. So there is a risk of being far from that because of the pressure on the budget in different donor countries, and one of our tasks is really to push these countries to transform their pledges into real financing.

Advanced economies also have an obligation to avoid protectionism. Developing countries have a growing dependence on trade, and so protectionism would impose significant costs to their growth. I’m not that much concerned about traditional protectionism, rising tariffs, or things like that. I’m very worried about the backdoor protectionism, which is in fact repatriation of capital. Most of these low-income countries, as well as emerging countries, have relied during the last decade on a large inflow of capital. These inflows of capital are now drying up because of this policy of repatriating the capital from the western banks, and this kind of -- as I say -- backdoor protectionism may hurt those economies very badly.

Of course, it’s not only a question of bilateral donors. An international organization must also play its part. So I welcome the efforts being discussed by the World Bank and ASA, an institution speaking for the IMF. I want to assure you that the Fund is mounting an extraordinary response to this extraordinary crisis. Last year, we significantly stepped up our financial assistance to developing countries hit by the food and fuel price shock. Twenty-three new financial arrangements and 12 increasing financing for existing arrangements have been managed, and so as a result of that, our concessional lending to low-income countries has doubled. You have here very striking figures showing the change between 2007 and 2008. As far as the total amount is concerned, a breakdown into a new financial agreement and limitation of access in the existing arrangement. And I'm expecting that a number of new or scaled-up loan agreements will appear very soon.

So looking ahead, my goal is to double our concessional lending capacity, which will make available $11 billion to support the low-income countries in concessional financing during the coming five years. And I also want our lending facility to the low-income countries to become more flexible because it’s one thing to get the resources; and another to make it available and tailored to the needs of those countries. So we’re working towards making progress on this front, and I think that by April, before the spring meeting, all of this will be completed.

We also are doubling our efforts to support countries through non-financing channels. We’re working with them on crafting an appropriate policy response to the crisis. We’re stepping up our technical assistance, including by opening four new regional technical assistance centers. And we also aim to bolster the role of developing countries in the ongoing policy debate, including by speeding up the reform of the IMF quotas.

As you just said, to discuss this and the challenges faced by Africa, President Kikwete of Tanzania and I are convening a major international conference in Dar es Salaam next week. We expect 300 participants coming from all the African countries, policymakers, private sector people, civil society also. And that must be an opportunity to exchange ideas on how to confront this crisis, to take stock of what has been done well and what has been done not that well in the last decade, to try to take advantage of the future, to look forward and have the different countries face the crisis. So I expect this conference in Dar es Salaam to be a very important part not only for the African countries to discuss together, but also for the IMF to get the feedback on what has happened both in Western Africa and in Eastern Africa, also in the southern part of the region where a different kind of policy has been implemented, and on the IMF programs or IMF advice, and to be able to take stock and to frankly and candidly discuss the quality of the result we update.

Let me conclude by reiterating my simple message today. The world is facing an unprecedented crisis, and it demands bold and concerted action. Attention has not only been focused on advanced economies, and that’s right because the longer it takes for them to recover, the longer the rest of the world will suffer. Attention has also turned rightly to the impact of the crisis on emerging markets. But now a third wave of the crisis is hitting the low-income countries. And we cannot act as if this crisis is still only a crisis of advanced economies or even a crisis of advanced economies with consequences on emerging markets. Obviously, this crisis is now a global crisis, even if it takes some delay for the rest of the world to be hit, and now the crisis is hitting hard on the low-income countries. So our duty is to ensure that the most vulnerable countries, and, in those countries, the most vulnerable part of the population, are not forgotten. Now it’s time for the world to come together. Now it’s time to provide rapid and generous support to those countries that need it most. Thank you.

MR. ANTHOLIS: Thanks. While our panelists get microphones attached to them for the conversation -- and I think the mikes are clipped to your chairs behind you, and we’ll get them attached. Why don’t I briefly introduce our panelists, starting at the end.

All three are Senior Fellows in Brookings at our Global Economy and Development Program, which has been run by Lael Brainard so marvelously for the last three and a half years, something like that -- you lose track.

Homi Kharas is a Senior Fellow and is part of the Wolfensohn Center for Development. Homi has worked at the World Bank and is an expert on, in particular, among other things, on aid and aid effectiveness.

Mauricio Cárdenas, Senior Fellow and the Director of our Latin America Initiative, served as Minister for Economy in the government of Colombia.

And Eswar Prasad joins us after a career at the IMF -- so a bit of a reunion -- where he among other things was responsible for China studies as well as international finance studies.

So I'll start with a quick question to Managing Director Strauss-Kahn about the upcoming G-20 meeting in London and including the meeting you'll have in Tanzania. As a tee-up for that meeting, how do you hope those two meetings connect? What do you hope might come out of Tanzania that might then lead to an effective gathering of the G-20 in London?

MR. STRAUSS-KAHN: As you all know, the G-20 has existed for a long time at the financial minister level, and since the meeting that took place here in Washington on November 15, the meeting level has been enhanced to the level of head-of-state in government, which means it is given more political momentum. So we are having a preliminary meeting of the financial ministers of the G-20 in mid-March, and then they expect a meeting of heads of state at the beginning of April. The problem with the G-20 is that on the one hand, it’s a good thing to have enlarged the G7 and G8 to emerging countries and was long over due. And so the answer which has been given to us certainly is the right answer. But when you have 20 countries in the room, even if it’s the 20 countries with the biggest GDP, then if you refer to the IMF membership of 185 members, then you have 165 countries out of the room. And so the question of legitimacy of this body is obviously at stake, especially the African countries. But when you say African countries are represented by South Africa, it's already the beginning of a problem. So those African countries fear rightly that a decision could be made at the global level by a kind of governance body of the world economies without their voice and their comments. So I think that Goldman Braun, who is very carefully managing the G-20 meeting of April 2nd, is trying to invite the African countries or maybe some others. That's a good thing. But on the other hand, the IMF can also play this role. We're a member of the G-20 and I feel, myself, as having a mandate from all of my 165 members not being represented in the room. And so the Tanzanian Conference will be a possibility to have a discussion with them, at least the African part of them, to know what the expectation is looking forward to this G-20 and what kind of message they want me to convey. So from this point of view, the IMF can certainly be the spokesperson or the spoke institution -- I don't know if you would say this in English -- and let's say the spokesperson of African countries not being directly represented at the G-20.

MR. ANTHOLIS: And in that role, what can the group of less-developed countries gathering together in Tanzania do to help you in that role? Are there things that they can bring to the table, key messages coming from those countries? You know, the crisis was not caused there. They're feeling the impacts in a pretty dramatic way. Your going around the world, asking for help on their behalf, what can they do to help you in making that sale?

MR. STRAUSS-KAHN: Well, you know, it's my role to go around the world and asking advanced economies, governments, to provide more concessional resources. But, of course, I'm very strongly helped by the voice of the countries benefitting from those concessional lending. It's vocal, and if they explain that this is not only figures which I've computed in the building here in Washington, but that it is really in the field and that the needs are urgent needs. So the more vocal they are, the more helpful it will be for me, and the more convincing I can be when I'm going to knock the door of Tim Geithner here, Lagarde of France, Darling in U.K., and others.

MR. ANTHOLIS: Now one last question and then I'll get a few questions from panelists and open it up to our audience. You were a politician in an industrialized country before. Politics is a big part of the confidence game that's going on right now, that we're all trying to restore confidence in the economy, and there's an economic dimension, but there's also a political dimension to that. How do these broader concerns about development and developing countries play into that in your view? Is there a political case that can be made back in the industrial world for why this kind of action is critical?

MR. STRAUSS-KAHN: Yeah, I think there's obviously a political case. There are also a lot of forces pushing it the other way around. And, you know, when you have this kind of meeting, we're talking about like the G-20 where you have the 20 most important countries in terms of GDP, heads of states of governments, sitting around the table, they all agree with the fact that you need a coordinated approach, that you need to take care of emerging countries, and also low-income countries. I mean, consensus is rather easy to obtain. And then they're back home. And when they're back home, they have domestic problems, they have their own positions, they have elections in a few months, they have demonstrations in the streets, and I won't say all of them, but some may forget the commitments of the day before. So there's a real need to always and always come and reiterate the need for multilateral approach to a global crisis, to take into account what's happening not only in your own country, but also what's happening outside, including here in the U.S., where the crisis originated, which is the biggest economy in the world. I fully understand that the new administration is most focused on what's happening in the U.S., but they must have a look on what's happening abroad, and especially in developing countries. It's certainly a case to make today are the problems coming from the crisis, but on top of the fuel and food crisis of last year in those developing countries.

MR. ANTHOLIS: Eswar, to turn to you in the run-up to the G-20, or moving from the meeting in Tanzania to the G-20, what's so striking about this crisis is the response to it is not one that industrialized countries alone have to do, but some big developing players are pretty important. A China fiscal stimulus package, the role of developing countries in actually jumpstarting the economy again. Give us your thoughts about that and how it relates to the role that the poorer countries play as well.

MR. PRASAD: Well, first of all, I would have preferred to have my reunion under better circumstances, but here we are. It is a grim time, indeed, in the world economy with the international financial institutions essentially vigorously competing with each other to show the bleakness of their forecasts and the data, unfortunately, proving all of us behind the curve. And, of course, when it comes to countries, it's much harder to talk about collateral damage in electively neutral terms.

The real solution again has to come from the big countries because as the Managing Director pointed out, the third wave is hitting the shores of the low-income countries, but arguably these problems did originate in the advanced countries, and then in the second wave in the emerging-market countries. And surely they're a part of the solution. And the solution, of course, is to take a variety of dimensions -- the Managing Director has already referenced certain important parts of that. One is get those economies going -- the big, industrial economies -- as well as the large emerging-market economies. Second, trying to make sure that protectionist policies do not take hold, not just explicit, but also implicit protectionist measures, which arguably hit the low-income countries the hardest. But my concern is that in the process of trying to get the economies going -- and arguably there are drastic steps that I think do need to be taken right now -- if you think global macroeconomic imbalances were a critical part of the crisis, at least if they fomented the crisis, then the question is whether as we come out of the crisis we're going to be in a situation where the problem is behind us or whether the problem is going to be exacerbated. And one concern of mine is, indeed, that these macroeconomic imbalances, if anything, are going to get worse because the paradox of this crisis is that despite the U.S. being at the epicenter of it -- as the MD referred to it -- it has arguably become still the demand of last resort and the safe haven of last resort for money that is trying to find a safe place. So my fear, in fact, is that if the emerging-market economies, especially the large ones like China, cannot pull it together and create a domestically sustainable recovery driven by domestic demand, we could end up with this problem being exacerbated. Now, of course, many of the major countries, the U.S. included, have been talking about the medium term. But it is one thing to talk about the medium term, but another thing to get there. And I fear that that is one thing that we'll have to keep our eye on and hear whether the IMF can actually play an effective role in terms of trying to defuse the macroeconomic imbalance situation. I think it's a very important issue.

The other issue that the IMF faces, of course, is another ironical one in terms of the symmetry of the advice it is giving to countries. The U.S. is in a desperate situation. China's in a not quite desperate, but still in a difficult situation. And so is the case of other emerging markets. And the IMF, I think, is correctly arguing that they should be using conventional and unconventional measures in terms of monetary and fiscal policies. And yet when one reads this paper that the IMF has put out, one senses attention there in terms of telling these low-income countries a slightly different message that they shouldn't be too aggressive on fiscal policy, that they shouldn't be too aggressive on monetary policy. Now this inconsistency, of course, is because of the way things are. Life ain't fair. And the fact is that a country like the U.S. or China has much more resources to be able to use these policies much more effectively. And these low-income countries, which are much more dependent on the rest of the world for their very survival in some cases, are not going to be able to take such effective policies. But from the IMF's point of view, I think getting this nuance in the message across is going to be a really challenging task because the obvious question can arise, and it has arisen, why there is this apparent asymmetric advice being given to the rich countries which followed a particular growth model which ended up in some ways not seeming to work very well. And essentially, we are allowing the rich countries which fomented the crisis to, in fact, encouraging them to undertake unconventional policies while we are trying to stick with what I think of as IMF orthodoxy for the low-income countries.

The bigger issue is what the LICs make of this difficult situation. In the U.S. -- of course, they've gone through a fairly large political change as well -- but there is a very significant sense that the nature of the game is going to change, that the growth model in some sense may shift in certain ways. The role of the government may shift in certain ways, and the way the financial system is set and regulated is also going to shift. We see similar changes in many emerging-market economies; with China, for instance, trying to use its stimulus package, to the extent possible, to shift its growth towards domestic demand. Although, again, in the interim we may end up with a more investment-led economy, which is quite the opposite of what the authorities have been trying to achieve. Now the low-income countries are, of course, already in survival mode, but the question becomes does one use this opportunity for them to actually make significant progress in terms of the very basics of reform? And here again one has to step back and think about what this means. We used to think that we had a fairly clear model of what it meant to think about reforms and growth. But that model to some extent has been discredited. So I think we need to go back and in all humility as economists -- and here it's not just the IMF, but as economists in general -- to think much harder about the growth model that we should be talking about to these countries.

MR. ANTHOLIS: I want to draw this point and the one before it back to the Managing Director. Do you feel a tension between different messages or that there's a bit of a mixed message going on with the massive stimulus and spending that the big industrial countries are doing and the continued tones of austerity being sent to the developing countries as a way of making them more attractive for concessionary lending?

MR. STRAUSS-KAHN: I'll try to answer this question, but first I would like to say a few words about the first point you raised, which is the point concerning global imbalances. We all have been talking a lot about global imbalances before the crisis, and there's no reason why because of the crisis we will just forget these global imbalances. As you say, we just don't know if those imbalances are going to appear at the end of the crisis as a growing problem or as partly source problem. We will see. But my point is that even if the global imbalances obviously don't help to solve the crisis, they're not really at the root, in our view, of the crisis. The root of the crisis is a problem which later was regulation of the financial sector and the way the lack of regulation of the financial sector spilled over on the real economy. Let's imagine a world where you wouldn't have had these global imbalances, namely that the current account of the U.S. will be close to zero, the current account of several countries will be close to zero also. And in this world, you still will have this huge development of risky assets, a very low standard in the banking system to provide loans and all this accumulation of private indebtedness. You may have a crisis which would look very close to the crisis we are contemplating today, even without the global imbalances. So I'm not saying that the global imbalances are not adding to the crisis, but I don't believe that they're really the trigger of the crisis.

Nevertheless, you're perfectly right in saying that as soon as the financial crisis and the world economic consequences are a bit behind us, the question of those global imbalances will come back. Except in the case where the solution to the crisis will by itself provide some solution to the global imbalances, and when I say that, I'm thinking of what may happen in China where a more domestic-led growth model rather than an export-led model may be part of the solution to the global imbalances.

Now let's come to the second question, the one you're underlining. It's a very interesting question, but I won't say that we have different advice to low-income countries or to advanced economies. We have different advice to countries having some fiscal space, fiscal room, or monetary room to ease the policy in countries being constrained. The fact is that most of those countries having some room are developed countries, and most of the countries not having this room are emerging or low-income countries. But the difference is not between advanced economies and emerging or low-income countries. It’s the difference between countries likely to do something, having the fiscal room or monetary room to do something, and those that don’t. For example, China is welcome in having an expansionary policy. I won’t put China among the developing economies, not so far. And obviously we are pushing, we are encouraging China to go on with the big stimulus they announced, even if we can’t discuss the content of this stimulus. On the other hand, some European countries are just unable to provide any kind of fiscal stimulus because their fiscal situation and the system, ability system, ability of their debt, do not allow them to do so. So really we don’t have two kinds of policy. Depending on who we’re talking with, we have different kinds of policy depending on the different situation or different economy. And the change is that we are probably totally out of this period where the IMF has a one-size-fits-all policy. So we really try to tailor the advice we give to the different kinds or the situation of the different countries. And maybe you remember, it was one year ago that for the first time I was asking for fiscal stimulus and at that time, the sky was blue and most governments said we don't need a fiscal stimulus. It's very surprising to see the IMF asking for some fiscal support. And even at that time, I said where it was possible. And the fiscal department in the IMF had made a study explaining that more or less 50 percent of all GDP was in countries likely to have some fiscal stimulus. And 50 percent of all GDP was in countries unlikely to have this kind of fiscal stimulus, but it had nothing to do with being developed countries or being low-income countries. It's a very important point to make, and thank you very much for raising this question because I don't want to give this impression. On the contrary, I want to fight against this wrong impression that the IMF wouldn't have an even-handed policy and would not consider all the economies in the same way.

MR. ANTHOLIS: Mauricio, this concept of fiscal space is a pretty important one, particularly in your part of the world in Latin America. Are there places that you worry about as you look at Latin America and the impact of the crisis where it's going to stretch countries that are coming up against their physical -- their fiscal -- space? And where should we be looking for places where the rubber will hit the road on that?

MR. CÁRDENAS: Yes, well thanks, Bill. I'm delighted to be here and delighted to be part of this panel. Let me answer that question by first making a reference to the conversation that is now being launched with this report. I think we're having four conversations in the world today. We're having the conversation about international financial revelation as a provision, which is a conversation mostly between the European Union and the U.S. We're having the conversation about the seats and shares and, in general, the governance structures of the multilateral institutions. And in that conversation, the key players are the larger, emerging countries. We're having our third conversation, which is the conversation about the capacity of the multilateral institutions to deal with this crisis, and particularly to provide the necessary lending to countries that may be cut off from capital markets. And what the IMF is doing here is proposing a fourth conversation, which is the conversation with the low-income countries. And I would add to the Managing Director's comments that it is probably the most important conversation of the four because we must not forget that we're in the middle of a very deep crisis. And I think we have to distinguish between the long-term and the short-term concerns, and to me this is a particularly pressing problem in the short run. And I think the other conversations, particularly the one about financial regulations and provision, and maybe also the one about the seats and the chairs and the shares and the election of the heads of these institutions, are more medium-to-long conversations.

So thinking about Latin America -- in Latin America you have the two groups of countries. You have the large, emerging countries like Mexico and Brazil that will be sitting at the table during the G-20 meetings. And for them, probably the most important aspect to this cause is how to replenish the capital of these institutions so that in the event that there is a sudden stop in capital flows to the region, these institutions are ready to provide the necessary funding. But in Latin America you also have these modern countries that are in the group of the low-income, like Bolivia, like many of the Central American countries, some in the Caribbean. And for these countries I don’t think this is about the ability to answer your question, Bill, to adopt contra-cyclical qualities. I think the conversation’s about how to avoid adjustment, how to continue providing these countries with a lending that will allow them to keep running government expenditures at their current level. And that, of course, is the intention of this report, as I see it, as I read it, which is to create a facility of about $25 billion that allows these countries to act in a very expedited way without much of the conditions that have been typical of the IMF, and also that it's flexible enough that these countries really have the capacity to borrow rapidly. So I think this is very important because in these countries, we're not saying that the crisis is not going to be severe. The crisis is going to affect them, but with these types of mechanisms, it's not going to be as deep as it otherwise would. So I think that's the importance of these methods.

Let me finish just by saying that for the larger, emerging countries -- the Chiles, the Perus, the Colombias, Mexicos -- there is a pending conversation there, which is that so far the repercussions of the crisis in the north have been mostly experienced through a reduction in exports -- in export volumes, in export prices, in consumer confidence to some extent, in business confidence as well, in remittances for some of these countries, which has decelerated growth say from the 5 percent to the low of 1 percent. And that's more or less the effect of the crisis. But this has been possible to a large extent because these countries have been able to adopt contra-cyclical policies, especially a reduction in interest rates and an increase in government expenditures. The fiscal stimulus for these large countries in Latin America has been on the order of 1 percent of GDP, less than what the IMF is advocating, but still important. But all of this has been possible because we haven't seen a major reversal in capital flows. There has been a deceleration in capital flows, but these countries are still net recipients of capital flows. If there is an event -- and we cannot ignore that possibility of a major reversal in capital flows -- these countries will not be able to adopt contra-cyclical policies. And that's when the IMF has to be ready to come in. And here we're not talking about the $25 billion that is being announced today, we're talking about $250 billion. And that's when we need to resolve the issue of the capital of these institutions. And also we need to make it more flexible for the banks, like the IDB, to borrow more so that they can in turn lend more if the issue of raising capital becomes difficult.

MR. ANTHOLIS: Thank you. Couldn't agree more. In some ways that then connects to Homi and something that you had mentioned in your remarks, which is the importance of aid effectiveness in helping those countries that are then stretched, right? Because the closer they come to -- the more difficult it is for them to do what they were already trying to do in filling the things that are easiest to cut or maybe shouldn't be cut from budgets, but sometimes they're easiest to do, direct assistance to people. Homi, does that fit in in the right way or are you feeling that countries are stretched in the places where they need to provide direct aid?

MR. KHARAS: I think that for a lot of the low-income countries, they are still heavily constrained by resource availability. And the part of the conversation that I think is most disturbing is that the urgency of the impact on low-income countries hasn’t yet been matched with an urgency of changing the policy response and what is being done. I don’t think there are any low-income countries as yet that have introduced stimulus packages, and they’re not really being encouraged to introduce stimulus packages. And then there’s a sense that well, maybe they can’t because they don’t have the fiscal space. So what is this fiscal space? The median low-income country debt to GDP ratio is 36 percent of GDP. So that means half of all low-income countries have public debt levels which are below 36 percent of GDP. This is a worry. It’s a worry because these countries have just been through major rounds of debt cancellations, but there’s a reason why they went through that major round of debt cancellation. It was to give them the space and the ability to then be able to do something if they run into serious problems. Well, if this crisis isn’t that serious problem, what are we creating this fiscal space for? The median deficit of a low-income country after grants is 1.8 percent of GDP. These are not, you know, these are not huge, enormous levels that we are talking about. These are actually rather conservative numbers. So it strikes me that there is much more fiscal space in low-income countries for doing a lot of things than they're being given credit for. A lot of these countries have already been through major programs of reform under HIPPIC, multilateral debt reduction initiatives, et cetera, to try to be sure that the monies that they spend aid resources on, the projects they spend aid resources on, are actually effective projects. So if they've gone through those kinds of hoops and thresholds, why do we know say yes, but still we're not quite sure -- I mean that's only a six-year track record of, you know, actual policy improvement to get your HIPPIC debt reduction. Maybe they're still not quite ready to be able to do additional public spending. This just doesn't jive with what the urgency of the crisis is. If you take out Pakistan -- I don't think people would attribute the problems of Pakistan to the global financial crisis, I think they are something quite different --

and you look back, over the last six months the IMF has managed to lend $250 million to low-income countries. On average, an IMF program in a low-income country is 35 percent of quota. On average, an IMF program in an emerging-market country is 650 percent of quota. We’re talking about a difference of roughly 20:1 in terms of resources that are available. If you look at the World Bank in IDA, growth disbursements actually fell last year in FY08 relative to FY07. In the first six months of FY09, IDA managed to do somewhere in the order of $4 billion of new commitments. IDA’s lending on average over the course of a fiscal year is about $9+ billion. So we’re not talking about big changes. We’re basically talking about business as usual in a lot of these institutions. And we’re talking about a sense of risk and the tolerance for risk being exactly the same as it was before this crisis. And we’re not recognizing that the big issue for a lot of these countries is the risk of inaction rather than the risk of action. If growth falters, progress on MDGs goes out of the window. The ability to restart growth goes out of the window. There's a great deal of evidence that there is a tremendous asymmetry between growth accelerations and growth decelerations in terms of impact on development. We know that maintenance of public assets suffers. We know that human capital development suffers. If you have interruptions in these kinds of development programs, you don't just get back to where you were before once things recover. These are long-term, very expensive, interruptions. There are no mechanisms today for actually preventing those interruptions if we keep going with a business-as-usual kind of attitude. And while I welcome the call for more aid, the time lags between raising the money, putting it into programs, getting it out to countries, is long. So the real question to me is how are we going to take the money that's already there, that's already on the table, and get it out to low-income countries faster? The multilateral development banks have over $60 billion U.S. of projects that have already been committed. They've already been vetted.

Supposedly these are good development projects. They have over $60 billion of that money, which is undisbursed. Why can't we get a lot more of that money through the pipeline? So I think when we talk about aid effectiveness, when we talk about fiscal space, when we talk about the risks, I think the risks that have to be addressed have to be tempered against the risks of inaction. And I think the really good news now is that there's a growing recognition that the risks of inaction, the risks of business as usual in terms of development outcomes, are really very high and growing significantly, and I hope that at some point that translates into much more aggressive actions on the part of the international community, using instrumentalities that they already have in place and resources that they already have in place much more aggressively.

MR. ANTHOLIS: You certainly have talked about the urgency. Do you feel that there's the ability to move quickly?

MR. STRAUSS-KAHN: Before that, I would like to make two small comments on what has been said. Namely on the reason for the size of the program we may have in emerging countries on one hand and low-income countries on the other hand. There are two big differences, which have to be taken into account, which don't totally destroy the argument which has been made about at least which may qualify. The first one is that for lending to low-income countries, we tried to do it mostly through concessional resources, which are not the same as the way we're lending to emerging countries. And, of course, it may be a bit technical a question, but nevertheless the pool in which we're likely to use concessional resources is not as big -- it should be bigger -- but it is not as big as the pool we may use for emerging countries. That's why I'm asking for doubling this amount of concessional resources, but it's two different kinds of funding.

The other point is that one of the reasons why the programs are so big in emerging countries is that we're facing a new kind of crisis, which is a crisis in the globalized world, meaning that the spillover from one country to another one is one of the important things we have to take care of. And for instance, when you're looking at Eastern Europe and the program in Latvia, for instance, the program in Latvia is huge compared to the size of the Latvian economy. Why? Because it's not only the Latvian economy which is at stake. I could say the same thing with Hungary. The problem is the risk of unraveling an older Eastern Europe. So we are acting and acting very strongly -- maybe not strongly enough, the future will tell us -- but very strongly on some countries irrespective of the size of this economy. And probably the way to appreciate and to measure the size and dimension of the IMF relative to the GDP of the countries is a bit outdated. It was accurate when the consequence was some spillover maybe to some other part of the same region, but not big spillover. Having said that, what has been said is not wrong, and certainly the urgency to act in low-income countries has not been underlined enough, and I'm hoping that what we doing today and what the IMF will do in the coming days will bring renewed interest and attention to this question.

MR. ANTHOLIS: I want to open it up now to the audience for questions. We've got about 20 minutes left and we can take maybe two or three questions at a time and then get our panelists to respond. So, yes, this gentleman here with the glasses.

MR. MUNOZ: Thank you. I'm Cesar Munoz with FNU Service. I wonder if the Managing Director or the panel could comment on the issue of the banking crisis. You mentioned it in your introduction, as something that required more intervention. And, specifically in the European Union, do you think that there should be some kind of fund for banks that are exposed to Eastern Europe, the Austrian and the Italian banks?

And if I may, a second question on the issue of protectionism. Do you think that aid to all the companies is protectionism? And this “buy American” provision here in the United States, is that protectionism?

MR. ANTHOLIS: This woman in the back, half way. Right there, yes, thank you.

MS. FEENEY: Thank you very much. My name is Kathryn Feeney. I’m with the United Nations World Food Program. President Zoellick recently called for the establishment of a global recovery fund with the suggestion that a certain percentage of the stimulus packages from the advanced economies be given towards that global recovery fund. I’m just wondering what your thoughts are on that? Thank you.

MR. ANTHOLIS: And then this gentleman here with the beard.

MR. GALLAGHER: Thank you for the excellent presentations. I’m Mark Gallagher. I run USAID’s fiscal reform and economic governance program. A year ago, the IMF announced large reductions in force, and I understand today they’re looking to hire 100 economists. Now that we’ve done the analysis and everything, is the IMF ready to step in and help mitigate the crisis in these developing countries.

MR. ANTHOLIS: To our panelists are questions about the banking crisis, protectionism, the global recovery fund, and capacity to help.

MR. STRAUSS-KAHN: Well, on the first question, the concern about Eastern Europe is a very certain one and the fact that probably a more comprehensive approach has to be considered with very strong attention. The first paper written by the IMF on the situation in Eastern European countries was from September. And at that time, again, it was very difficult to attract attention to this problem because the problem wasn't obvious. It is today. It was not six months ago. During this time, the difficulties have increased and obviously now we need to consider all the Eastern Europe countries as a whole. It's very difficult to reason. The first one is that they are different. Some are outside the European Union, some are in the European Union, but outside the Euro Zone, some may even be in the Euro Zone. And the second reason is that the political machinery of the European Union works well in good times, but appears to be a little less effective when you're in a tempest. And I'm wondering if it will be possible during the G-20 meeting to have a real boost by the political leaders to be able to address this question in the European Union and Eastern Europe. Ten years from now when we look back to the crisis, I wouldn't want for this crisis to finally appear as originating in the subprime market in the United States, but be labeled as a European crisis. And the possibility we just counter just to estimate.

Now the second point on protectionism. What was the point exactly?

MR. GALLAGHER: Aid to automakers, buy American --

MR. STRAUSS-KAHN: Well, I told you it's traditional in crisis to have this kind of answer. A politician has to face their own citizens and taxpayers and gives them answers to questions they ask. The experience shows that it never has helped at the global level to have this kind of a policy, but as I told you, I'm more concerned today by this kind of new financial protectionism than by this traditional wave of protectionism. And you are absolutely right in saying that we need an experience today that would stop after founding of a low-income emerging country, but it may happen. And if those policy groups that are creating the terrible flows in domestic countries by most American or Western European banks goes on, if rollover stops, then the situation of most emerging countries and low-income countries will be much more difficult than the one we have today. So I'm more worried about this kind of new protectionism -- I call it backdoor protectionism -- than the traditional way of doing it.

Global recovery fund -- you must be French to like these kinds of things.

MR. ANTHOLIS: The French ally of Bob Zoellick. Sounds like --

MR. STRAUSS-KAHN: Well, obviously, we are facing something which is global, I think is really the first time. And so it's obvious that facing this global crisis, we'll need a global response. Does global response mean that everything has to be centralized and on only one hand and only one institution, but centralized? Not sure. I mean we may have a different way to address the problem in different countries, so some flexibility has to be allowed. But at least coordinated action is absolutely needed. It's needed when you're talking about the stimulus. I think the IMF played this role correctly -- correctly, I don't know -- courageously at this point. It's needed on the restructuration of the banking sector and I'm afraid that the coordination today is not that good. But it's also needed when trying to collect funds for vulnerable countries. And when Bob Zoellick is trying to build this vulnerability fund, I think he's right in doing so because afterwards -- as he said himself -- the money can be used by different kinds of programs, world food programs. All by itself, the IMF is doubling the concessional resources. But having an overarching concept to try to explain the problem and to convince donors is a good thing after the implementation. When you go to action, then those different fields are more effective.

MR. ANTHOLIS: Someone asked is the IMF ready to --

MR. STRAUSS-KAHN: Yes! Ready to what?

MR. ANTHOLIS: Dot, dot, dot. It was the --

MR. STRAUSS-KAHN: Well, yes, yes. Well, the IMF has been criticized a lot in the past years because seeing we're apparently doing well, growth was there, and IMF has no program anymore but here. We're doing our business as usual which is the bread and butter of the IMF technical assistance in most countries, spending 70 percent or 80 percent of our resources in technical assistance, but since we're doing well. So, yeah, no headlines about the IMF and even some very smart people, including in this city, were asking finally do we need an IMF? It's exactly the same thing to ask, do we need a firefighter when you don't have a fire? Then the fire comes back, and it appears that the firefighter may be useful. So are these firefighters ready to address the crisis as it is today? No. That's why we're asking to change the facility. We're in the process of doing that. Increasing the resources because the crisis is much bigger than the previous one and probably bigger than could have been expected one year ago. So we need a lot of changes, including changing the legitimacy of the institution and that goes back to the questions and so on. So I won't answer "we're ready." We're just trying to adapt to a changing situation. And in this situation, you have the problem of the low-income countries. Maybe you have in mind the discussion from three or four years ago -- the question was should the IMF be involved in low-income countries or not? It was argued at this time that the low-income countries were a question for development banks, the World Bank, IDB, African Development Bank, and that the IMF should focus only on emerging countries. Nobody was talking about advanced economies at this time. So this has been proven wrong, and the need perhaps through the

IMF for balance of payment problems and budgetary questions and low-income countries is obvious. So I'm really committed to defend and to fight against this idea that the IMF should not be involved in low-income countries, and the report we're releasing today is part of the attitude change to this question.

MR. ANTHOLIS: Let me take some of these questions to the rest of our panelists. Mauricio, maybe you could take on the protectionism question. How much do you worry about the various bailouts, or elements of them, being protectionism, and how much is that something to pay attention to moving forward?

MR. CÁRDENAS: Yes, indeed, of course, that's something to worry about. Not just because of the more evident trade protectionism, but also because of this backdoor protectionism that Mr. Strauss-Kahn was referring to. And I think that connects with the question that was raised about whether a fixed percentage of these stimulus packages should be directed towards basically low-income countries. I guess your question was whether we could sign onto that -- I definitely will sign that, but you have to convince people on the Hill to sign those proposals. But more seriously, I think this is a crisis, and crises are opportunities, good catalysts to produce changes. The G-20 heads of state in November said that this is an opportunity to move forward on the Doha Round. Let’s hope that that’s true. Let’s hope that there’s really an impetus to finish that conversation. But also it’s a good opportunity, for instance, to reach agreements on things that have been difficult in the past. And let me illustrate this with an example: Energy, which is a topic that is in almost every single speech of President Obama. Wouldn’t this be a good opportunity to lift or start reducing the tariff on ethanol, importing ethanol here in the U.S., and allowing more trade on something that is very good for the long-term health of this economy and that will also create new opportunities for exports in countries in many parts of the world, particularly in the low-income countries in the region of Central America and the Caribbean? So protectionism is a fear, it's a valued one. The constituencies the Managing Director was mentioning are there and are certainly pressing for that, but we should also seize the opportunity and move forward on issues like Doha or the introduction of protectionism in specific areas like energy.

MR. ANTHOLIS: Eswar, do you want to talk about the banking crisis and what the next waves of it might look like?

MR. PRASAD: Before I start, though, the one good thing about having left the IMF is that I can disagree with the MD.

MR. STRAUSS-KAHN: No, the change at the IMF is that you can disagree with the MD even if you're in there.

MR. PRASAD: Times have certainly changed, but I just want to come back to --

MR. ANTHOLIS: That's why it's now an institution where it's not only okay to disagree with the MD, it's part of what people do here on a constant basis, so --

MR. PRASAD: I'm glad the IMF is adapting. On the issue of macroeconomic imbalances, my view -- and this relates to the banking question -- the macroeconomic imbalances certainly were not the root cause and I would agree with that. But ultimately I think we would have had a bubble and not really the sort of cataclysm that we ended up with if we had financial systems and macro policies working well. And I think the critical issue here again is the linkage between the macro policies and the financial systems. And here again my concern is that the way the banking crisis has evolved -- in the industrialized countries to begin with -- but in the secondary emerging markets, we could end up with a situation where effectively they're trying to get a stimulus through the advanced economies. And in the U.S. in particular, now that the private consumer is not in a position given that he or she has to be able to balance sheets, it has to be government demand takes up much of the charge. Then we end up with a situation once again where countries with financial systems that are not working very well, like China, end up not being able to reenter the economy in quite the way they would like. But in terms of banking I think the critical issue is once again to think about what the right principles of regulation are. And the IMF is certainly doing very useful work in this regard. To me there are just far more unanswered questions, and the notion of trying to increase regulation or make regulation more effective I think is something that will have to come after we get out of this crisis because trying to reinvent regulation in the midst of the crisis I think does pose fairly serious resistance. This, again, is fairly consistent with the IMF message. But ultimately, we are going to have to think about coordination of financial policies at a broader level. But to me the root issue still where the IMF I think has to play critical roles in terms of the macroeconomic imbalances because ultimately, no matter what the problems are in the financial system, that’s where one explosive power of the crisis comes from.

MR. ANTHOLIS: On the question of a global recovery fund, Homi, do you care to comment on that?

MR. KHARAS: Well, I think it actually illustrates something which is really lacking in the development architecture, and that is any kind of instrumentality for responding to short-term events. Basically, development finance has been geared -- at least in the international financial institutions -- towards long-term development programs. And if there’s a sudden crisis, the only thing you can really do, that those agencies can do, is take money away from what were thought to be long-term priorities and use that money to address short-term priorities. That’s terribly unsatisfactory because the tradeoff is really expensive. Other than with humanitarian organizations, there is no mechanism for short-term, temporary crisis mitigation. The IMF is not geared up to lend money to governments to support counter-cyclical budget operations. If governments want to spend more on, say, safety nets, that’s not the purpose of the IMF. They don’t have the instrumentalities to really do that. So I think the great part about the vulnerability fund that President Zoellick has proposed is that I think it recognizes that here is a big missing element of the aid architecture that ought to be put in place. Now whether that's going to be of any use for this crisis is rather a different question. You know, a lot of governments have frankly already been submitting their aid budgets, so whether or not they're prepared to put in supplementals to try to get more money now for this crisis is quite a different question. There doesn't seem as yet to have been a tremendous response to that suggestion. But I think longer term, having some recognition that one needs some kind of a short-term, counter-cyclical mechanism, which is different from your mechanisms for long-term development financing, is a very useful idea.

MR. ANTHOLIS: Well, with that I think we've come to the end of our session. I really want to thank Managing Director Strauss-Kahn for spending the time with us, as well as our panelists and all of you.

This is a terrific, challenging set of issues out there. In addition to architecture, we're trying to save a burning building, and we really thank one of the world's leading firefighters for being with us here today. So thank you all.

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