Testimony submitted to the House Committee on Financial Services, Subcommittee on International Monetary Policy and Trade, hearing on "Implications of the G-20 Leaders Summit for Low Income Countries and the Global Economy," May 13, 2009 (embargoed until 10am).

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Main points

1. Low income countries have been severely affected by the global economic downturn. Many of the worst consequences, including on the poorest people, have yet to be felt.
2. In that context, by contributing to the stabilization of the world's financial system, the G-20 summit had a positive effect. However, it left open a large number of important issues, some of which call for immediate congressional attention.
3. First and foremost, low income countries need to receive considerable additional resources in order to weather the crisis. This crisis is not of their making and, prior to this shock, poorer countries were making considerable progress along the lines of implementing exactly the policies advised by richer countries and the International Monetary Fund (IMF).
4. The IMF has adapted its standard forms of conditionality to current circumstances. The goal of protecting core social spending is commendable and long overdue, and the implementation in recent East European and Pakistan programs is encouraging. However, the retreat from structural conditionality has probably gone too far and needs to be reappraised; the weaknesses of low income countries arise from and are manifest in disproportionate power of key individuals or sectors, and this needs to be addressed in a transparent manner wherever the IMF is engaged. In situations where such issues have been taken on board – as with transparency for extractive industries – the reception among civil society has been very positive.
5. The potential US legislative package (including IMF gold sales, its new income model, and $100 billion for the New Arrangements to Borrow) is worth serious consideration but also needs careful congressional review. The $250bn issue of Special Drawing Rights is a bold move which, while it involves some risks, is well worth taking – hopefully, this will be regarded as a pilot project for potentially larger increases in resources for troubled countries, on an "as needed" basis.
6. The G20 called for $6 billion of additional concessional resources from the Fund over the next 2-3 years for Low Income Countries, including some vague phrasing on money from gold sales. So far, the gold piece of this puzzle remains stalled at the level of the IMF's executive board. More transparency around board discussions on this and other items would reveal who is holding up change and for what reason.
7. Providing additional resources to low income is a very good idea, and increasing the resource flow from and through the IMF is timely and appropriate. If these resources can come from

[1] This testimony draws on joint work with James Kwak and Peter Boone. Our updates and detailed policy assessments are available daily at http://BaselineScenario.com.

"extra" proceeds from gold sales, that would be an attractive solution – particularly as the income model needs some adjustment in the light of (a) the increase in Fund lending over the past 12 months, and (b) the introduction of the Flexible Credit Line, which offers the promise of Fund revenue even during quiet times for the global economy. However, it is too early to determine how profoundly the Fund's income model will be affected by this crisis and how the world responds.

8. As long as the Fund lends at concessional rates to low income countries (and the relevant, Poverty Reduction and Growth Facility interest rate is only 0.5% per year currently), loans may be attractive relative to grants – the key issue is the resource flow that is available, i.e., does lending allow more transfers in a meaningful and sustainable manner. Avoiding unsustainable debt burdens is of course of paramount importance.
9. Most important, we should take all available actions to shore up low income country defenses against this crisis. We should also guard against any form of complacency.
10. For that reason, it is most important that the IMF be authorized to restore its budget to its early 2008 level (i.e., before the 15-20% across the board cuts were implemented). Cutting the budget and letting go some of the most experienced IMF staff was the unfortunate result of gross macroeconomic negligence at the level of leading industrialized countries, including the US and its G7 partners. At the same time as the IMF was warning, clearly and firmly, that a global crisis was developing, major shareholders pushed through budget cuts that resulted in some of the IMF's best people leaving the organization.
11. Undoing the budget cuts would be embarrassing to leading European countries, but it should fine support from the Obama Administration – after all, it was their idea to make increasing IMF resources a central issue at the recent G20 summit. The IMF simply does not currently have sufficient skilled staff to undertake all the important tasks it has been asked to handle.
12. The G20 summit effectively agreed to end the European monopoly on the position of Managing Director at the IMF. Since the summit, there has been some indication of backsliding on this issue, but assuming that European countries can be kept to their commitments, this would be a major step in the right direction. Given that the next leadership change is likely to take place in a little over a year, identifying and supporting sensible candidates from emerging markets would be most constructive. If an Indian or a Brazilian, for example, could be brought in as Managing Director, that has the potential to greatly expedite the rebuilding of the IMF's legitimacy and its engagement throughout the developing world.
13. Unfortunately, IMF credibility has been somewhat damaged by its inability to follow through on exchange rate surveillance, particularly with regard to China. While there seems to be a movement towards implicit agreement among leading countries, in and around the G20, to take this issue of the table, that would be a serious mistake. Countries must not think that competitive devaluation (or even sustaining accidental undervaluation) is a sensible or attractive policy. This will lead to greater global imbalances and potential instability, as some countries compete to get current account surpluses and other countries – willingly or not – run deficits.
14. Unless and until countries are assured that there is an effective international lender of last resort, they will be tempted to try to accumulate large amounts of reserves. This creates problems for reserve currency countries (e.g., the United States) as well as for the global system as a whole. We need an international system that can handle these issues and prevent

them from becoming destabilizing. The IMF should be given another chance to show that it can help run the global system in a constructive fashion. This is of paramount importance for the United States and for everyone who wants to participate in an open international trading system – particularly low income countries, which have few other opportunities to grow and which remain highly vulnerable to shocks of all kinds.

The remainder of this testimony provides background on the current global economic situation and its most likely development over the next 12-24 months. This will be a primary driver of outcomes in low income countries.

Global Economic Outlook

The global economy remains weak across the board, although the fall in global output may now be bottoming out. Some forecasters are beginning to recognize that growth in 2010 is not a foregone conclusion. The OECD, for example, now forecasts contraction of 4.3% in 2009 for the OECD area as a whole - and 0.1% contraction in 2010. This is broadly with an "L-shaped" recovery view.

Even that forecast, however, expects quarter-over-quarter growth rates to be positive beginning in Q1 2010. (This is not a contradiction: if growth is sharply negative in early 2009, then quarterly rates can be positive throughout 2010, without total output for 2010 reaching average 2009 levels.) While most forecasters expect positive growth in most parts of the world in 2010, those forecasts seem to reflect expected reversion to the mean rather than any identified mechanism for economic recovery. The underlying assumption is that at some point economic weakness becomes its own cure, as falling prices finally prompt consumers to consume and businesses to invest. But given the unprecedented nature of the current situation, it seems by no means certain that that assumption will hold. In particular, with demand low around the globe, the typical mechanism by which an isolated country in recession can recover - exports - cannot work for everyone.

U.S. Outlook

Like the global economy, the U.S. economy only looks worse than it did two months ago, with some financial market stabilization but no definite indicators of an incipient recovery. The underlying causes of economic weakness are largely unchanged and widely known:

- De-leveraging by consumers (paying down debt, voluntarily or involuntarily), leading to reduced consumption and increased saving
- De-leveraging by companies, leading to reduced investment
- Reduced supply as well as demand for credit, constraining even those who want to borrow and spend
- Continuing falls in real estate prices

This combination of reduced spending and reduced credit has sharply depressed aggregate demand, creating a classic vicious cycle where reduced demand leads to reduced economic activity which leads to reduced spending power via increased unemployment and reduced corporate profits. In addition, concerns about financial system solvency are constraining the ability of financial institutions to supply the credit needed by the economy. There will likely be a rolling wave of defaults and debt restructurings in the US and around the world over the next couple of years; this is hard to avoid and constitutes a major reason why the recovery will be slow compared with previous recessions.

On balance, we believe that the Obama administration and Fed Chairman Bernanke are making every effort to combat the financial and economic crisis. However, some aspects of the response, most notably the fiscal stimulus, have been underpowered. And a combination of ideological and political constraints has hampered the administration's efforts to rescue the banking system. For these reasons, we still do not see the mechanism that will cause the economy to turn around.

In this context, we interpret the recent stock market rally as indicating that the economic decline is slowing; it does not necessarily denote that rapid recovery is just around the corner.

International Issues

The lead-up to the recent G20 summit exposed some of the tensions between the U.S. (and the U.K.) and Europe when it comes to economic policy. To generalize, Europe (led by Germany and France) favors less fiscal stimulus spending, more fiscal discipline, and lower inflation risk; the U.S. favors more stimulus and more expansionary monetary policy, at the risk of higher inflation.

We favor the U.S. position, for a simple reason. Not only is the current global recession very severe, but it is unlike any we have seen before, and therefore we cannot rely on historical patterns to tell us when and how the recession will end. In that context, and with unemployment climbing virtually everywhere, it makes sense to do more rather than less to turn the economy around. The European position is that their more advanced social welfare systems will both limit human misery and provide an automatic fiscal stimulus, both of which are true. However, European economies are just as vulnerable as ours to a prolonged period of deflationary stagnation - a risk that, unlike Ben Bernanke, they seem willing to take.

Given this divide in opinion, there was no chance for a meaningful resolution at the G20 summit. However, the G20 did have some notable achievements. First, increasing funding for the IMF to $1 trillion gave it the capacity to actually bail out multiple mid-size economies, which may become necessary as the recession progresses. Second, by eliminating Europe's de facto control over the IMF (and the U.S.'s de facto control over the World Bank), the summit gave other members of the G20 more of a stake in helping develop and support concerted international solutions to the economic crisis. While this could take months or years to pay off, it is an important first step.

Further coverage of the crisis and policy proposals (a partial index, with links)
Background material
Financial Crisis for Beginners primer, includes material on "bad banks" and the Swedish approach to cleaning up the banking system: http://baselinescenario.com/financial-crisis-for-beginners/

Deeper causes of the crisis, an ongoing series: http://baselinescenario.com/category/causes/

Previous editions of Baseline Scenario:

- September, 2008 (first edition): http://baselinescenario.com/2008/09/29/the-baseline-scenario-first-edition/
- October 2008, 2nd edition: http://baselinescenario.com/2008/10/06/the-baseline-scenario-2nd-edition/
- Mid-October: http://baselinescenario.com/2008/10/13/baseline-scenario-101308-analysis/ and http://baselinescenario.com/2008/10/13/baseline-scenario-101308-policy/
- Late October: http://baselinescenario.com/2008/10/19/baseline-scenario-102008/
- November: http://baselinescenario.com/2008/11/10/baseline-scenario-111008/
- December: http://baselinescenario.com/2008/12/15/baseline-scenario-121508/
- February: http://baselinescenario.com/2009/02/08/baseline-scenario-2909/
- April (post-G20 summit): http://baselinescenario.com/2009/04/07/baseline-scenario-april-7-2009/

More on Europe
The European crisis, why the Europeans are not coping, and what to do about it
http://baselinescenario.com/2009/02/22/the-choice-save-europe-now-or-later/
http://baselinescenario.com/2009/01/05/eurozone-hard-pressed-2-fiscal-solution-deferred/

Our original European stabilization fund proposal:
http://baselinescenario.com/2008/10/24/eurozone-default-risk/

More on current US and global topics
Strategies for bank recapitalization
- Economic ideas: http://baselinescenario.com/2009/01/27/to-save-the-banks-we-must-stand-up-to-the-bankers/
- Guide to evaluating official announcements: http://baselinescenario.com/2009/02/07/ten-questions-for-secretary-geithner/

Global fiscal stimulus: http://baselinescenario.com/2009/01/21/global-fiscal-stimulus-should-it-be-an-obama-priority/

Citigroup bailout (the second round): http://baselinescenario.com/2008/11/27/international-implications-of-the-citigroup-bailout/ and http://baselinescenario.com/2008/11/24/citigroup-bailout-weak-arbitrary-incomprehensible/

Policy recommendations from October/November 2008
"The Next World War? It Could Be Financial" (October 11, 2008):
http://baselinescenario.com/2008/10/12/next-up-emerging-markets/

Pressure on emerging markets (October 12, 2008): http://baselinescenario.com/2008/10/12/next-up-emerging-markets/

Pressure on the Eurozone (October 24, 2008): http://baselinescenario.com/2008/10/24/Eurozone-default-risk/

Testimony to Joint Economic Committee (October 30, 2008):
http://baselinescenario.com/2008/10/30/testimony-before-joint-economic-committee-today/

Bank recapitalization options (November 25, 2008):
http://baselinescenario.com/2008/11/25/bank-recapitalization-options-and-recommendation-after-citigroup-bailout/