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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.