Overcoming the Great Recession

An Address to the Japan National Press Club, Remarks by John Lipsky, First Deputy Managing Director of the International Monetary Fund
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I last visited Tokyo exactly a year ago. At that time, the prevailing view was that the fallout for Asia from the U.S. slowdown and global market turmoil would be limited. This optimism was based on several factors: Asian banks were not major players in structured finance. Instead, banks in the region had remained focused on traditional banking services and sustained little damage when the subprime train derailed so dramatically. Moreover, less traditional export markets, such as in Latin America and the Gulf countries, were holding up well despite the US slowdown, as they were buoyed by the commodity price boom that persisted through mid-2008. Reflecting these and other factors, most analysts — the IMF included — expected Asia to be fairly resilient to the subprime crisis.

Things look very different today. The global economy since has tumbled into a severe recession. Our recent *World Economic Outlook* and Asia *Regional Economic Outlook* publications fully describe the events leading up to the sharp deterioration in global activity that began in last year's fourth quarter. They highlight the financial market dislocation that began in mid-September, combined with the evaporation of consumer confidence in advanced economies once job losses loomed and credit availability was curtailed sharply. The pullback by consumers has reverberated in export-dependent economies, including many in Asia, while the sharp correction in commodity prices in the second half of last year caused many new markets for Asian exports to contract as well.

In the first part of my remarks, I will dig a bit deeper into why the impact of the crisis on Asia has been so severe, describe the region's anti-crisis policy response, and discuss the outlook going forward. I will not discuss Japan explicitly, since I will have occasions this week to discuss Japanese developments in the context of the current IMF staff visit for the annual "Article IV" update. In the second part of my speech, I will turn to the broader question of how the international community, including the Asia region, is responding to the global crisis. In particular, I will outline the various ways in which the IMF is contributing to the global response to the crisis.

First, why has Asia been hit so severely by the global slowdown?

In the fourth quarter of last year, global GDP fell by an unprecedented 6 percent at an annualized rate, and it likely declined at a similar pace in the first quarter of this year. The downturn in Asia was even sharper. GDP fell by an astonishing 15 percent on a seasonally adjusted annual basis in the fourth quarter in Emerging Asia, excluding China and India, and by almost as much in Japan.

Several elements were responsible for this much worse than expected outcome: once the financial crisis intensified in the second half of last year, consumers in the U.S. and other advanced economies became dramatically less willing and able to purchase consumer durables. This led, for example, to Japanese auto exports dropping by nearly 70 percent since September 2008, while Asia exports of DRAM chips and other semiconductors have fallen by similar magnitudes. In fact, there is a very strong correlation between the fourth quarter output decline across Asian economies and advanced manufacturing's share in their GDP, including automobiles, electronics and machinery. Moreover, the shock has propagated rapidly through the region's tightly integrated supply chain, with a dramatic impact on intra-regional trade. Of course, this trade shock also spilled over to domestic demand, as consumption and private investment weakened as well. One fact will help to demonstrate the scale of the problem: Business fixed investment in Japan and the Newly Industrialized Economies (including Korea, Hong Kong SAR, Singapore and Taiwan Province of China) fell by 15 percent year-on-year in the fourth quarter of 2008—close to the peak decline during the Asian crisis.

Asia also has turned out to be far less insulated than anticipated from financial market turmoil. While the sub-prime crisis did not pose a direct threat to Asian banks, the indirect impact of the global financial disruption on the region has proved to be extremely strong, reflecting Asia's increased financial integration with the rest of the world. In fact, Asia has experienced a "sudden stop" of capital, as a result of the global crisis. International bank flows to emerging and industrial Asia declined by a massive $295 billion in the fourth quarter of 2008, the worst showing on record (that is, since BIS data began to be collected in the late-1970s); regional equity markets experienced net outflows of $90 billion over the two most recent quarters; and external corporate bond financing dried up almost completely. All of this has contributed to sharply slowing or contracting economies and weakening currencies in much of the region

On a positive note, progress made throughout the region over the last decade in strengthening economic policy frameworks has made it possible to respond forcefully to the crisis both by easing macroeconomic policies and by undertaking a range of steps to preserve financial stability. These efforts should and will continue. With output gaps large and inflation under control, there is scope in many cases for reducing interest rates further. Maintaining sufficient foreign exchange liquidity will be important, including through the use of reserves or via bilateral swaps where available.

The Asia region has been proactive in implementing fiscal stimulus for 2009 and, given the expected duration of the downturn, additional efforts could be needed next year.

Further strengthening of bank capital also may be necessary in some cases in order to limit adverse feedback loops between slowing economic growth and deteriorating loan portfolios. While Asian banks' balance sheets remain reasonably healthy, Japan's own experience suggests that preemptive efforts to shore up capital and maintain confidence in the financial sector can have important benefits. Finally, it may be prudent to prepare for the possibility of possible corporate failures, by ensuring that legal frameworks allow for orderly debt workouts.

I am pleased to note that there have been some encouraging signs of late, in part reflecting the strong policy actions already taken in the region. Credit market dislocations have receded and financial market sentiment has improved. In some countries, business and consumer confidence appear to be bottoming out. And we are seeing signs that excess inventories have been run off while exports and production are starting to stabilize.

Nonetheless, many uncertainties remain, and the prospects for a broad recovery in Asia will depend on the speed of the global economic turnaround.

Our *World Economic Outlook* anticipates a return to global expansion by next year. Thus, as the global economy revives in 2010, Asia should as well. However, the recovery is likely to be more gradual than in past recessions. We are now projecting that the economies of Emerging Asia, excluding China and India, will contract by nearly 3 percent this year before returning to modest growth of about 1½ percent in 2010. Even in China and India, growth is set to slow significantly, although of course from a much faster pace. In China, in particular, massive public investment is expected to help compensate for weaker external demand and private investment, and to help maintain overall growth at around 6½ percent. But China's resilient domestic demand is likely to be of limited direct help to the rest of the region, given the relatively low import content of public investment.

Global Challenges: Overcoming the Great Recession…and Afterwards

Turning to a broader, global perspective, it is clear that the current crisis — that is coming to be known as the Great Recession — is far from over. Already, however, it has provided many important lessons, and it has motivated important changes in attitudes, organizations and actions. In particular, there is little doubt about the striking degree of interdependence that lies at the heart of our globalized economy. It has become clear to all that overcoming the crisis requires decisive, coherent and mutually consistent policy efforts that are best developed and implemented in a cooperative manner. It is also clear that a more collaborative, multilateral approach to economic and financial policy issues will be required in the future if global growth potential is to be realized fully and if stability is to be reestablished and sustained.

The unprecedented anticrisis action that has been driven by the innovative G20 Leaders' Summit process is beginning to produce positive effects. For the near-term, however, the IMF has been emphasizing three essential messages: First, the restoration of financial sector functionality in the advanced economies is a necessary condition for renewed growth. The principal goals are the restructuring of impaired financial institutions where needed, and the rapid thawing of frozen markets. Even taking into account the strenuous efforts that have been implemented in many affected markets, additional efforts will be needed if success is to be achieved, even though the decisions that will be required will be neither easy nor politically popular.

Second, sustained fiscal effort remains necessary. On a positive note, the discretionary fiscal stimulus being applied in 2009 is unprecedented in both scale and scope, totaling about 2 percent of GDP for the advanced G-20 economies, approximately the same degree of fiscal stimulus that is being applied in Asia. This is exactly the degree of action that the IMF had suggested would be appropriate. Moreover, the impact of this effort is being multiplied by its simultaneity. IMF analysis indicates that fully one-third of the expansionary impact of the fiscal stimulus reflects spillover effects from stimulus-driven trading partner demand.[1]

When automatic stabilizers are taken into account, the amount of G-20 fiscal effort already anticipated in 2010 will remain similar to that in 2009. However, fiscal authorities need to retain a flexible stance, anticipating the possible need for new policy action, while also embedding any stimulus in a medium-term fiscal framework, providing assurances of sustainability. These considerations hold equally for the Asia region.

The third message is that concrete action is needed immediately to insure that emerging market and developing economies are cushioned from the double blow being delivered by the simultaneous drop in international capital flows and in external demand.

Updating the IMF's Toolkit to Meet Global Challenges

Looking beyond the challenge of overcoming the Great Recession, key reforms will be required to sustain more stable, better balanced and more durable global growth. These reforms include improving the IMF's anticrisis toolkit through improved financing mechanisms and by strengthening the monitoring of economic and financial developments.

This double list of daunting tasks that will be needed both to cure the crisis and afterwards represents a particular challenge to the IMF, as the organization has responsibilities and involvement in virtually every aspect. However, the Fund's current and prospective role shouldn't really represent a surprise, as the Fund possesses both a near-universal membership and a unique constitutional mandate to establish and sustain economic progress and stability. It is called on to help provide financing and to insure global liquidity, and it is directed by its Articles of Agreement to conduct candid, independent and evenhanded monitoring of the international economic and financial system.

In order to fulfill its responsibilities successfully, however, it has long been clear that the Fund needed to implement several important improvements. Representing one of the few positive implications of the crisis, it appears today that there is a realistic opportunity to achieve substantial, perhaps historic, progress in strengthen the both IMF's toolkit and its governance.

More than anything else, the explosion over the past two decades in cross-border capital flows, intermediated increasingly in the form of securitized financial instruments rather than traditional bank lending, changed the nature of the international system's stability challenges. The current crisis—that originated in a narrow segment of the U.S. housing market and eventually spread explosively to every corner of the world—has conclusively demonstrated the depth of financial integration and the increasingly complex web of spillovers between financial markets and the real economy..

The sudden stop over the past year in international capital flows — especially to emerging market and developing economies — has presented a dramatic challenge to the Fund's financing role. As the crisis unfolded, the IMF has been helping emerging markets—most notably in Central and Eastern Europe—with large financing packages to help overcome financing constraints, and to mitigate the economic and social costs of the crisis.

In a world of high-volume capital flows that can change course swiftly, IMF financing packages must be large enough to make a difference. But Fund assistance also must be available in forms that are appropriate and effective. For countries that need to adjust macroeconomic policies in order to restore stability, traditional Fund adjustment programs remain relevant, so long as they are well-designed and adequately scaled.

In recent years, some countries have been reluctant to turn to the Fund until their situation had become acute, in part for fear of excessively burdensome conditionality. In response, we have streamlined our conditionality in order to focus our adjustment programs only on those elements that are essential for meeting basic stabilization and growth goals. Moreover, we are approaching the current crisis in a flexible way. For example, because at present weak external demand will afflict emerging market economies until advanced economy growth can resume, we are encouraging the use of countercyclical policies where appropriate. This means relaxing fiscal targets in program countries when it is prudent.

Of course, Fund conditionality remains important as a safeguard of success. In some cases, moreover, conditionality is aimed protecting the poorest and most vulnerable by sustaining social expenditures. The main point is that the combination of appropriate scale and focused conditionality should encourage member countries to address problems early, substantially enhancing the prospects for effective anti-crisis action

Perhaps the most serious weakness in the Fund's toolkit has been the absence of a crisis prevention instrument that could have an impact in a world of fast-moving securitized finance. For example, rather than merely bemoan "investor contagion", as in past episodes, the Fund needed to have instruments that would reduce the risk of investor flight that is motivated by avoidable information asymmetries. In short, the absence of an effective insurance facility has been a major gap in the global financial architecture.

Many countries, especially here in Asia, instead opted to self-insure by building large foreign reserve buffers. While this might make sense for a single country, it is almost certainly suboptimal from a global perspective. As a better alternative, it has been the Fund's intent that countries that are following appropriate policies should be able to count on the availability of adequate liquidity insurance, provided in a multilateral fashion that is consistent with improved global balance.

Accordingly, the crisis helped to convince Fund members to approve the creation of a set of new precautionary insurance facilities. In March, the Flexible Credit Line facility was established, providing rapid upfront financing in large amounts—with no ex post conditions—for countries with strong economic policies and a proven track record. Mexico, Poland, and Colombia already have tapped this new facility, and it will not be surprising if other countries follow in the not-too-distant future. Early experience suggests that this new facility enhances FCL user's financial market standing and this bodes well for the future. For other countries that can benefit from a large precautionary arrangement, but that are in need of policy adjustment, we have created the High Access Precautionary Arrangement, or HAPA.

We also are modifying our concessional lending facilities to enhance their flexibility and usefulness to an increasingly diverse set of low-income countries. Already, we have doubled access limits on the existing set of concessional lending facilities. The IMF's Executive Board soon will consider a set of proposed improvements in the Fund's concessional facilities. The recent London Leaders' Summit endorsed a substantial expansion of the resources available to support our low-income members. This task is of the utmost importance, as the Great Recession is threatening to reverse the impressive progress that had been achieved by many developing countries during the past few years, and resources are needed urgently to protect the most vulnerable populations. For its part, the Fund intends to provide $6 billion in concessional resources to low-income countries over the next two years.

It is in the context of these essential reforms of IMF financing facilities that world leaders pledged to triple the IMF's lending capacity to an unprecedented $750 billion, and—in addition—to approve an allocation of $ 250 billion of Special Drawing Rights, while at least doubling the Fund's capacity for concessional lending to low-income countries.

As I am sure that you are aware, Japan is playing a leading role in ensuring these targets can be met, having already provided $100 billion in additional loanable resources to the Fund. We fully expect that others will soon follow Japan's example. The recently announced expansion of the Chiang Mai Initiative—that raises the available amounts to $120 billion and takes further steps to support the issuance of local-currency denominated bonds in the region—is another constructive development. The IMF welcomes this expansion of the CMI, and we look forward to exploring new avenues for collaboration created by our expanded toolkit.

The second broad area of IMF reform relates to our monitoring function. The Fund has played a leadership role in forming a consensus around the advanced economies' anticrisis policy response, and our basic multilateral surveillance instruments — the *World Economic Outlook* and the *Global Financial Stability Report*, — are benchmark references. Still, our record in predicting the scale and scope of the current crisis was not as good as it should have been. While we focused on many of the right risks in the run-up to the crisis, we were too optimistic about the economic situation in advanced economies. We issued warnings as risks accumulated, but these warnings were not as effective as they should have been.

Looking forward, the G20 Leaders, as well as our broad membership, have assigned us new responsibilities in improving the monitoring of systemic developments. In response, we have developed a specific program for strengthening our bilateral and multilateral surveillance efforts. We have bolstered our resources devoted to understanding macro-financial linkages, and we have expanded our analysis of country vulnerabilities to encompass advanced economies. Moreover, in collaboration with the newly-enlarged Financial Stability Board, we are developing an early warning exercise covering both advanced and emerging market countries, that is aimed at helping respond to prospective risks in a proactive fashion. But for IMF surveillance to be effective, member countries must be ready to receive candid and even-handed analysis. The early response from the G-20 and our Spring Meetings in Washington has been encouraging.

Improved monitoring and surveillance need to be bolstered by improved rules and standards, especially regarding financial markets. The Financial Stability Board will be taking the lead in drawing the specific roadmap for regulatory reform. While the IMF is an active member of the FSB, we are not regulators, nor do we aspire to such a role. However, thanks to our extensive hand's-on experience and our specialized expertise, we can contribute actively and productively to the discussion and debate at the FSB. At the same time, our monitoring and assessment activities — including through our Financial Sector Assessment Program (FSAPs) — contribute in a concrete way to the implementation of newly-agreed regulatory and supervisory standards. Moreover, we provide significant amounts of technical assistance in this area to our members around the world.

This is an ambitious agenda. For it to work, the Fund must be seen as credible and evenhanded. In fact, much hinges on legitimacy—whether countries will approach us to meet their financing needs early on, and whether countries will listen to our policy advice or take our early warnings seriously. Legitimacy binds everything together. With that in mind, we are speeding up our governance reform. In particular, Fund members have endorsed accelerating quota reform to early 2011, to help insure that voting power in the Fund more closely reflects members' relative economic weight. But IMF quotas are not everything. Dynamic emerging markets already are serious global players, and are being treated as such. Their voice in the policy debate increasingly is being heard, both inside the Fund, and in other global fora. And this is how it should be.

Concluding Remarks

To sum up, the current crisis has culminated in the risks and hardships of the Great Recession. But it also has inspired an unprecedented response, both in terms of strong anti-crisis policy measures, and in terms of potential structural changes in global markets and in international institutions. For its part, the IMF is adapting rapidly to a new global reality. These prospective developments provide key building blocks for optimism about the future. But this is no time for complacency, as serious challenges remain just ahead, and they must be overcome.

[1] That is, calculated relative to the outcome of a hypothetical case in which discretionary stimulus would have been absent.