Global recession watch

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G-20:

Focus on the G-20 Meeting

Leaders of the G-20, the advanced and emerging economies that account for 80% of global output are meeting in London this week to plan further coordinated responses to the financial crisis and global recession. This meeting, the second involving the heads of state of these countries following the one in Washington last fall, underscores the growing importance of emerging markets. Although there is increasing consensus on reducing the toxic assets on bank balance sheets, improved financial regulation, and boosting the resources of international financial institutions like the IMF, the members remain divided on additional fiscal stimulus. Meanwhile the economic outlook remains bleak

The EU's common strategy, released March 20, focused on regulating hedge funds, private equity, credit derivatives and credit rating agencies, and vowed to crack down on tax havens "non-transparent jurisdictions". The U.S. is basically on the same page with Treasury Secretary Geithner calling for a systemic risk regulator, and promoting a system of regulation by activity rather than by institution, thus encompassing all institutions trading in financial derivatives and hedge funds and major insurers such as AIG. Meanwhile, the ECB has recently signaled for the first time that it will follow suit with other major central banks that have already engaged in Credit or Quantitative Easing to various degrees.

According to press reports, the G-20 also plans to issue a set of guidelines for countries to use to rid banks of toxic assets. The ECB is said to be working on guidelines for governments that plan to guarantee toxic assets remaining on banks' books, whereas the European Commission prefers a solution where toxic assets are written off at market value, and where any write-offs will first have to come out of shareholders' capital. Once the capital falls below the Basel ceilings, it is up to the government to provide new capital, or to force the bank into bankruptcy procedures. In the U.S. Treasury Secretary Timothy Geithner unveiled the center piece of the U.S. Financial Stability Plan consisting of 1) "stress tests and capital assistance; 2) Public Private Partnership Investment Program (PPPIP) to price and remove toxic assets from the banking system; 3) the expansion of the Term Asset-Backed Lending Facility (TALF) to support the securitization market next to the homeowner affordability and loan modification plan.

The EU's common strategy does not include call for increased fiscal stimulus given the current size of the EU's overall fiscal effort, including the additional effect of automatic stabilizers, of around 3.3% of EU GDP, or over €400 billion, and concerns about the medium-term fiscal sustainability criteria of the Stability and Growth Pact. Individual EU leaders, such as Gordon Brown, have nevertheless signaled that they might consider further fiscal stimulus packages as warranted in their countries. The IMF has been pushing the G-20 countries to step-up their stimulus plan. Deficit countries such as the U.S. and UK support the idea of global stimulus given the severe recession and job losses, and to prevent import leakages through their own stimulus packages. However, surplus countries like Germany, France, Sweden and many others in Europe remain wary given the impact on rising fiscal deficits, government

Highlights

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debt and inflation at a time when massive U.S. debt issuance may crowd out debt issuance by other countries with implications for the exchange rate as well.

Going forward, bank bailouts and stimulus spending will raise pressure on budget balance and government debt when tax revenues especially from corporate incomes, dividends and capital gains are slowing significantly and Western countries face high health care and entitlement burden due to ageing populations. According to the IMF, G-20's government balance will deteriorate by 3.5% of GDP in 2009. Developed countries' deficit will rise to 7% of GDP in 2009 from less than 2% in 2007 and their gross debt-to-GDP ratio will rise by 15-20%. Emerging markets will move from a fiscal surplus in 2007 to a deficit of 3% of GDP in 2009. There are also suggestions that stimulus spending should be undertaken by surplus countries like Finland, Sweden, Luxembourg, New Zealand, Australia, China, and Germany while deficit countries such as the U.S., UK and Italy should increase savings rates as part of the re-adjustment. Oil exporting economies, especially in the Gulf, perhaps no longer surplus countries, are by and large continuing with their expansionary fiscal policy by drawing on past savings.

Several G-20 countries have already been implementing fiscal stimulus packages which the IMF estimates amount to 0.5% of GDP in 2008, 1.5% of GDP in 2009 and 1.25% of GDP in 2010 with one-third in revenue measures and two-thirds in expenditure measures, and mostly accounted by U.S., China and Japan. As the growth contraction in EU will be much worse than in the U.S., Europe might need greater fiscal stimulus despite more extensive automatic stabilizers than in the U.S. The impact of stimulus on growth depends on its size, multiplier effects in individual countries and time lags in implementation, and might be constrained by credit freeze in the economy. Measures undertaken so far indicate that they will fall short of the extent of contraction in global growth and private demand and job losses. Another risk is that it might be difficult for many countries to scale back the stimulus once the recovery begins, creating the risk of inflation and also difficulty of rolling back politically appealing tax cuts.

Going forward, while many countries might remain averse to a coordinated global stimulus, they will individually continue to dole out stimulus packages as economic conditions and job losses worsen. Nonetheless, given forecasts for global growth contraction and job losses during 2009-10, stimulus measures are needed in the form of unemployment benefits, social safety nets, food stamps, worker retraining and education programs, tax cuts for low income households and unemployed - though their size might depend on the individual countries' fiscal space.

While the G-20 countries have consistently pledged in the past to prevent reverting to import barriers, financial and labor protectionism, and such a pledge is likely to figure significantly in this week's communiqué, these forms of protectionism have in fact grown since the beginning of the crisis in late-2008 as the global economic and employment outlook worsen. Many countries have been raising tariff and non-tariff barriers, providing export subsidies, bailing out domestic firms and auto companies over national ones, instilling protectionist clauses in fiscal stimulus packages to encourage spending only on domestically produced goods and hiring of nationals. These measures will exacerbate the expected contraction in global trade and global excess capacity and deflationary pressures, increase global trade distortions, reduce effectiveness of global stimulus packages, reverse past gains from free trade and migration while having limited short-term impact on growth. Capital withdrawal by foreign banks especially from emerging markets and pressure by Western governments on banks to increase lending in domestic economy are raising the risk of financial protectionism which during the current

WHILE THE G-20 COUNTRIES HAVE CONSISTENTLY PLEDGED IN THE PAST TO PREVENT REVERTING TO IMPORT BARRIERS, FINANCIAL AND LABOR PROTECTIONISM, AND SUCH A PLEDGE IS LIKELY TO FIGURE SIGNIFICANTLY IN THIS WEEK'S COMMUNIQUÉ, THESE FORMS OF PROTECTIONISM HAVE IN FACT GROWN SINCE THE BEGINNING OF THE CRISIS IN LATE-2008 AS THE GLOBAL ECONOMIC AND EMPLOYMENT OUTLOOK WORSEN.

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crisis will have a greater impact on growth especially for countries that were highly dependent on foreign capital to drive domestic growth.

But in spite of further pledges at the G-20 and concerns voiced by many developing countries about this, these instances of protectionism and also competitive currency devaluation by some countries will prevail in the coming months as governments face political pressure at home amid credit crunch, export fall and large job losses. Countries can manage to raise tariffs without violating the WTO bound rates and there is no binding international organization to curtail labor or financial protectionism. Nonetheless, many countries increasingly also realize that in an intertwined global economy, protectionist measures by one country will lead to retaliation and therefore greater adverse impact on growth and employment.

Another issue on which the G20 members do agree on is about boosting the IMF's financial firepower and that of regional development banks to increase their ability to lend to emerging economies. IMF's executive board recently approved a major overhaul of IMF's lending framework, including the creation of a new Flexible Credit Line (FCL). The IMF's new framework includes new credit lines for strong-performing economies that need insurance and tailors loan terms to countries' varying strengths and circumstances. Additionally, the fund intends to modernize conditionality, adding more flexibility to credit lines, enhancing stand-by arrangements, doubling lending access limits, simplifying cost and maturity structures, simplifying lending toolkit, and reforming facilities for low-income countries. The changes follow many years of low demand for IMF assistance, contributing to its own budget woes.

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Several of Emerging Europe's fast-growing economies have already turned to IMF and EU for financial assistance. Most of those nations are suffering from sharply slowing economic growth, tough external financing conditions, elevated risk aversion and tense liquidity situation. In recent months, the IMF has committed roughly $48 billion to a variety of battered emerging economies, including Belarus, Latvia, Pakistan, Iceland, Ukraine, Hungary and Serbia. EU leaders called for IMF resources to be doubled to $500 billion to help head off new problems in countries already hit hard by the global economic and financial crisis. The U.S. has called for tripling the IMF's lending capacity but getting permission for its own contribution (possibly an additional $100 billion) may face a tough congressional battle. While some analysts believe the EU does not have sufficient resources to save Eastern European countries without the IMF help, the fund could have as much as $443 billion available when the recent loan from Japan is taken into account, comparable to street estimates of Eastern Europe's needs to cover loans and prop up the credit system. But will the channeling of funds reduce the vulnerability of those emerging European nations.

Asian countries like China, Japan, South Korea, India, Taiwan, Singapore and Hong Kong who hold more than $4 trillion in foreign exchange reserves - much of it in U.S. dollars are in a much better position. Asia's surplus position could be the ultimate source of capital to bail out the financial system, say by providing funds to the IMF to avoid further export contraction. Japan has already provided capital and China is reportedly considering a $40 billion contribution. However, China and other emerging economies would likely demand governance reforms including rebalancing the institution's voting power, likely at the expense of some European countries. In fact China comes to the G-20 table with a set of suggestions about international financial reforms – most significantly, the central bank governor's recent calls that the Special Drawing Right (SDR) might overtime supplant the US dollar as a reserve currency to avoid the instabilities of the current system. China has been extending swap lines to emerging and frontier economies including Indonesia, Belarus and most recently Argentina, perhaps providing an alternative or complement to IMF funding for such economies.

In Latin America, the external funding situation remains relatively stable but in the case of further deterioration

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of capital flows, the solid economies would be able to tap the IMF or the Inter-American Development Bank (IADB) for non-conditional lines of credit, while the economies with less sound macroeconomic frameworks such as Ecuador, Argentina and Venezuela would most likely only be able to obtain funds through more formal conditionality or by turning to lenders like China.

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IN LATIN AMERICA, THE EXTERNAL FUNDING SITUATION REMAINS RELATIVELY STABLE BUT IN THE CASE OF FURTHER DETERIORATION OF CAPITAL FLOWS, THE SOLID ECONOMIES WOULD BE ABLE TO TAP THE IMF OR THE INTER-AMERICAN DEVELOPMENT BANK (IADB) FOR NON-CONDITIONAL LINES OF CREDIT......