DEVELOPMENT COMMITTEE

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on the
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Statement by

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I. Global Economic Environment

Global economic crisis. Today, the world is faced with the worst crisis since the Great Depression. The financial crisis caused by the meltdown of the subprime loan market has triggered a storm of credit crunch all over the world through the globalized financial system. This has quickly spilled over to the real economy, with a dramatic decline seen in production and investments. The world economy is projected to contract by 1.3% in 2009, which represents a 5% swing in growth rate compared to last year. Economies of developed countries are projected to contract by 3.8%, while growth in developing countries is expected to slow down to 1.6%. This is a global crisis and we need global solutions. Both developed and developing countries must work together, and mobilize all possible policy measures. We must fix our financial system and strengthen regulations to recover the functions of our financial markets, and we must also adopt decisive fiscal and monetary measures to avoid global economic meltdown.

Economic policy packages of Japan. Fiscal and monetary policies of the world's major economies are essential to prop up aggregate demand of the world economy. Japan has been implementing economic policy packages totaling 75 trillion Yen (approx. $750 billion), including 12 trillion Yen of fiscal stimulus since last October. In addition to this, Japan has announced its new "policy package to address the Economic Crisis" totaling 57 trillion Yen (approx. $570 billion), including 15 trillion Yen (approx. $ 150 billion) of fiscal stimulus, which is equivalent to 3% of its nominal GDP. The immediate aim of the new package is to prevent the negative spiral between financial crisis and deterioration in the real economy. It also aims at achieving more balanced economic growth led by the "twin engine" of exports and domestic demand, by implementing policies that promote the transformation of Japan's economic and industrial structures, alleviating its dependency on exports. It is an effort to search for a new global equilibrium in anticipation of the inevitable and expected adjustment of the current excessive global imbalance.

II. How to Mitigate the Impact of the Crisis on Developing Countries

A. The Sharp Drop in Private Capital Inflow Caused by the Credit Crunch

Impact on developing countries and the projected slump in private capital inflow. The current crisis is causing serious damage to developing countries as well. In the first phase, middle income countries already integrated into the international financial market have suffered from financial difficulties, including a sharp decline in stock prices and tighter credit conditions for the public as well as the private sector. In the second phase, globally declining aggregate demand caused by the deterioration of the real economy in developed countries has seriously and broadly affected developing countries through reductions in export volumes, commodity prices, and remittances.

The hardship caused to developing countries appears prominently in the disastrous slump in private capital inflow, which had been a key element driving economic growth of the developing countries. The net inflow, which peaked at around $1 trillion in 2007, fell by half in 2008, and is likely to turn negative in 2009. This "sudden stop" in capital flow poses serious problems for fiscal management, and severely constrains private sector activities that are the critical drivers of economic growth. Therefore, mitigating the negative impact of this acute downturn in capital flow to developing countries is the first priority for the international community.

Japan's assistance. Japan's assistance to the developing countries has focused on this point from the very beginning. In an effort to enhance confidence in the financial systems of developing countries, Japan led the way in lending to the IMF with a pledge of $100 billion, and also established the Capitalization Fund, together with the IFC, to inject capital to banks in developing countries with contribution of $2 billion from JBIC (Japan Bank for International Cooperation), last November. Japan further pledged $22 billion for the next two years to support trade finance, as well as $5 billion in support for environmental investment in developing countries over the same time period.

Asian countries must take rapid and concerted actions to tackle the impact of the current financial and economic crisis, including strengthening growth and stimulating domestic demand, considering their large potential and expectations towards the Asian region as an open center for growth. In this regard, Japan has pledged to scale up Japanese ODA to the Asian region to $20 billion.

The role of International Financial Institutions. International financial institutions, including the World Bank Group (WBG) and the IMF, should play a pivotal role in bridging the huge financing gap of developing countries by maximizing the use of their balance sheets and mobilizing contributions from partner countries. In this regard, I welcome the near trebling of the IBRD lending up to $100 billion and the IFC's initiatives, including the Capitalization Fund and the trade finance facilities, and appreciate the efforts of the entire WBG to provide active leadership in assisting developing countries.

The expected roles of the World Bank Group. A significant increase in Bank's lending volume, however, should not compromise the quality of its loans. Even as a crisis response, the WBG needs to ensure that its financial assistance contributes to sustainable and long-term economic growth and to poverty reduction. I expect the WBG to maximize the development impact of its crisis response assistance by identifying and removing bottlenecks in economic growth through policy dialogues with client countries.

The Bank's increasing loan commitment should not act as a disincentive to clients to pursue capital market funding. Raising the level of interest rates and fees applicable to crisis-related DPL may be effective in this regard, and I expect the Bank to continue to explore these options.

As the Bank tries to meet the increasing demand from its client countries, we need to seriously consider to what extent the Bank's capital could be stretched, while maintaining its AAA credit rating. In doing so, it will be useful to make an accurate comparison of the capital situation in each Multilateral Development

Bank (MDB). Therefore, I would like to request the Bank to act as a focal point in putting together each MDB's financial data in a comparable manner and report back to shareholders on a regular basis.

B. Mitigation of the Negative Impact of the Crisis on the Poor and the Vulnerable.

The poor and the vulnerable will be hit hardest by the crisis. The current financial crisis could push additional 90 million people into extreme poverty, and we can easily imagine how the crisis could quickly wipe out the hard-earned progress that has been achieved by developing countries over a long period of time. We should also recognize that deepening poverty can harm children's healthy development through malnutrition as well as decrease in school enrollment, which will have a negative impact on economic productivity in the long run, and consequently hamper economic growth in the future. To protect human lives, livelihood and dignity, it is critical to promote a comprehensive human security approach, which not only protects individuals and communities, but also enhances people's ability to cope with crises through capacity development.

In this regard, we welcome the establishment of the Vulnerability Financing Facility (VFF), which aims at assisting such vulnerable groups. The Bank must first get a clear picture of the exact problems that the poor and the vulnerable are facing, and tailor its response accordingly. As the crisis becomes protracted, there will be increasing demand from IDA countries for timely assistance, and the needs and priorities of low income countries may have changed due to the crisis. I would like to propose to move up the IDA15 Mid-Term Review (MTR) scheduled for this November, so that we may be able to reconsider the priorities of the IDA15 as needed.

Crisis responses focusing on vulnerable groups through the JSDF. Japan established the Japan Social Development Fund (JSDF) in 2000 as a trust fund managed by the Bank, in response to the devastating impact of the East Asian financial crisis on vulnerable groups. Since then, the JSDF has accumulated ample experience and expertise by providing direct support to the most disadvantaged groups around the world using innovative approaches. In order to respond to this unprecedented crisis, Japan is going to launch the "emergency JSDF" and provide support in the amount of $200 million over the next three years. While supporting innovative and pioneering projects, the new emergency JSDF is designed to enhance its responsiveness to the crises, by introducing a streamlined procedure for project approvals and focusing on the scaling-up of projects adopting innovative approaches with demonstrated successful development impacts. Under the framework of the WBG's VFF, we would like to have the emergency JSDF closely collaborate with various initiatives including the Rapid Social Response Program.

III. Lessons from the Crisis

The world economy is inevitably being thrust into a large-scale adjustment process. The winding down of the excessive leverage in the financial system and the redressing of the global imbalance are unavoidable challenges, and such processes have already begun. Developing countries had until recently enjoyed steady economic growth supported by abundant private capital inflow and strong consumer demand from developed countries. Such favorable conditions, however, are gone. The current crisis is raising significant questions about how we should address development issues in the future.

Risks associated with short-term external borrowing. First, the current crisis made us realize once again how risky it is for the developing countries to rely on short-term external borrowing to meet their funding needs for development. Eastern Europe, which has been hardest hit by the current financial crisis, with its regional economy expected to contract by around 3% in 2009, is more heavily dependent on foreign bank borrowing than any other region. The amount of foreign bank borrowing by eastern European countries increased by seven-fold from $37.9 billion in 2000 to $260.3 billion in 2006, with their shares in GDP increasing from 4.2% to 10.4% over the same period. These figures are extremely large, as compared to the foreign-bank-borrowing-to-GDP ratio in other regions: 1.2% in East Asia, 2.6% in Latin America, 0.9% in South Asia, and 0.5% in Sub-Sahara Africa. Eastern European countries were financing a significant portion of their huge current account deficits by external bank borrowing, which made their economic structures extremely vulnerable to external shocks.

Efforts by Asian economies following the Asian currency crisis. Asian economies also suffered from rapid reversal of private capital flow during the Asian currency crisis. Having learnt their lessons from this experience, they have shed their dependence on short-term external borrowing and prepared for the risk of private capital flight. They transformed their economic structures and turned their current account into surplus, built up massive foreign reserves, moved to a more flexible exchange regime, implemented financial sector reform, established regional financial cooperation frameworks such as the Chiang Mai Initiative (CMI), and improved their internal resource mobilization by nurturing domestic securities markets. As a result of these steady efforts, the direct impact of the financial crisis (the first round effect) on the Asian economies has been relatively moderate.

Challenges for the future. The situation surrounding eastern European countries is substantially different from Asian economies. Many of these countries were in their path towards the introduction of the euro, and were in the midst of a process of rapidly catching up with euro-zone countries. They have seen rapid capital inflow largely from other EU economies, motivated by the expectation of future growth and stability supported by the liberalization of capital account transactions following their EU accession. Against this background, lessons from the Asian experience cannot be directly applied to eastern European countries, and therefore different crisis responses would need to be taken.

Based on the current status of eastern European countries, it will not be realistic or desirable to aim at immediately moving to current account surplus. However, it is not sustainable, either, to finance sizable current account deficits by foreign bank borrowing. Considering the magnitude of the economic and social costs associated with abrupt adjustments, it is vital to confine the current account deficit to a sustainable level, by restraining domestic demand through appropriate fiscal and monetary policies. Even when external private funds are to be utilized, more stable foreign direct investment should play a central role, with foreign currency lending by foreign banks to be subject to strengthened monitoring for prudential purposes. In cases where the room for capital control and foreign exchange adjustment is limited, a public back-up mechanism would be indispensable to properly prepare for private capital outflows, and international financial institutions would need to play a larger role.

Limitations of dependency on foreign demand and necessity for balanced economic growth. Second, another notable finding from the crisis is the limitations of the prevalent development model which relies on external demand. As considerable saving-investment balance adjustments proceed in the US and other developed economies, and the world economy has started rebalancing towards a new equilibrium, developing countries face an increased need to review their development model, which is contingent on ever-growing markets in developed countries, and to pursue economic growth with more balanced reliance on domestic and foreign demand.

Although Asian countries managed to avoid the first round effect of the crisis, they were not immune from adverse real economy effects, such as declining demand in developed markets and the consequent drop in exports. Their economic growth rate in 2009 is projected at 5.0%, a decline from 7.7% in 2008. This indicates the risk inherent in economies whose growth is heavily dependent on external demand. As economic recoveries in developing countries are expected to take some time, developing countries have little choice but to expand domestic demand to avoid further deepening of the economic downturn.

Expansion of domestic demand in developing countries is, however, not an easy task. They would need to seek out appropriate policies for domestic demand expansion, as well as new economic growth models tailored to their specific circumstances in a medium- to long-term perspective. Developing countries with relatively high returns on investments might want to improve productivity by making substantial investments, in line with their fiscal capacity, to relieve the shortages of infrastructure and human resources, which are the bottlenecks in future economic growth. Other developing countries which already have excess investment but a low share of personal consumption in GDP, might consider expanding consumption by transferring funds to the poor, who tend to have higher propensity for consumption, through strengthening the social security system.

IV. Voice and Representation

Emerging countries, which now play a critical role in the world economy, have come to assume significant roles in the development sphere as well, with corresponding growing responsibilities in development assistance. While one of the major mandates of the World Bank is to assist the poorest people and countries, fulfilling it would require sustaining IDA operations that offer concessional instruments for assistance, and thus contributions to IDA from emerging countries commensurate with their economic strength would be critically important. In discussing the enhanced participation of emerging countries in the Bank’s operation, an assessment of their respective weights in the world economy should reflect the Bank’s mandate as a development institution, by taking account of their contributions to IDA, not just their GDP and GNI.

We expect the high-level commission chaired by former Mexican president Hon. Zedillo, in addressing such issues, to have discussions from a broad perspective, considering the future of the Bank, and to provide insightful suggestions, based on the Bank's mandate as a development institution.